

**Goldman Sachs Exchanges: The Markets
Volatility, Earnings, and European Equities
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Sam Grobart: Markets have been pretty quiet lately. Have they been too quiet? This is The Markets, a new series from Goldman Sachs Exchanges.

Hi, I'm Sam Grobart. Today, I'm joined by Sharon Bell from our research group in London. We're going to talk about the calm in markets, European stocks, and her insights from the latest round of earnings reports. Sharon, thanks so much for joining us today.

Sharon Bell: Thank you, Sam.

Sam Grobart: So, Sharon, US equity volatility has been hovering around the lowest level since the end of 2021 according to the VIX index. Why do you think things are so subdued?

Sharon Bell: I think, partly, it's because the action has been in the last year or so on inflation and interest rates. It's been the Fed that's been doing a lot of the work in these last 12 months rather than so much on growth risks. And therefore, less on equities. More on rates.

Generally, to get a sharp spike in equity volatility, you need to be looking at a recession quite near-term. And so far, with the emphasis on so far, growth has been okay. That said, clearly the economy is slowing. And we don't think equity volatility will stay this low. A little bit depends on the stocks within the market. And the US market's quite concentrated in those big cap tech stocks that we all know about. And I think they've been doing quite well. And that's cushioned volatility as well.

Sam Grobart: It does seem like there's been a little bit of a push/pull hasn't there been between those bigger, as you were just describing, those sorts of mega cap tech stocks as opposed to, perhaps, other parts like, say, some regional banks, right?

Sharon Bell: Absolutely. I agree. That's helped bring down overall volatility. Small caps have done poorly. The regional

banks, obviously, have been volatile and very weak. But those big cap tech stocks, and the index has quite concentrated them, have done well.

And so, the correlation between stocks is quite low. Under the surface, there's been lots of action. Even if it doesn't look like it, if you look at the overall level of the VIX, for example.

Sam Grobart: Right. Let's pull back and look across markets a little bit. Are different markets telling us different things? For example, we've got the treasury market, the US equity market, and the options market. Are some more bearish than others?

Sharon Bell: So, I think there are some things which are quite striking. The yield curve has inverted. And when the yield curve inverts, most people would see that as a sign of a recession, of impending recession. But on the other hand, the equity market seems okay, despite the stresses in banks that we just mentioned. The S&P 500 is up this year. It's up around 5 or 6 percent. And the NASDAQ is up more than that, double digit returns so far this year. So, that looks reasonably strong.

But again, I think this has something to do with the mix. It's a narrow group of companies driving equities up, which is large cap, tech-driven companies. For them, a slower economy with interest rates starting to peak and expectations for interest rates eventually coming down, that's not that bad news for these stocks.

But if you look elsewhere, you see a less rosy picture. So, the Russell 2000, which is the small cap index in the US, that's down year to date. The Dow, which is a bit more old economy, a bit more cyclical in its makeup, that's flat year to date. Also, investors have been highly into money market funds since the start of March because of the concerns and stresses in the bank sector. And generally, we've been seeing outflows from equities.

Sam Grobart: I want to sort of move on to a geographical plane as opposed to a sort of cross markets one. You recently wrote a report about European stocks and how they are currently trading at a substantial discount to US equities. What are some of the key reasons for that?

Sharon Bell: So, put very simply, the PE of the US equity market is about 18 to 19 times. In Europe, the price earnings ratio is about 12 to 13 times. So, there is a big gap between the two markets. European companies in aggregate for the index overall are much cheaper than US companies. Europe trades at about a 30 percent discount to the US, placed on most metrics. I mentioned PE. But you could look at other ones: price to book, cashflow yields, etcetera. And you'd find the same type of result.

But the very first pushback I get is that Europe's got different sectors. Of course, I'm going to pay more for an index which is more concentrated in tech companies, has delivered me better growth over time, such as the US index. Whereas Europe's got more banks. It's got more oil companies. It's got more autos, which tend to trade on lower valuations.

Europe does historically trade at a discount to the US. But typically, on the same sector basis, it would be about 10 percent. And at the moment it's about 20. So, I do think it's larger than normal.

Sam Grobart: But I've got to ask you. If European

stocks trade at a discount, does that mean they are potentially an opportunity for investors?

Sharon Bell: Yes. We do think so. We would argue Europe still looks good value versus the US. Something we've been arguing for the last six - eight months. Europe has been outperforming. And you have seen a bit of the gap between the US and Europe narrow a little bit.

If we see a recession in the US or elsewhere, then investors tend to go to the safety of the dollar. They tend to go to the safety of the US market. I think assuming we don't get such a big downturn, then yes, I think European stocks represent better value at the moment than US ones.

Sam Grobart: We've obviously been in the midst of big earnings report season. Here in the US, we've seen mega cap companies reporting better than expected results. What have you been seeing over in London as you turn your attention toward European companies?

Sharon Bell: Yeah, this is a good question. The earnings season is the main topic at the moment. And look, so far, I think on both sides of the Atlantic, the season hasn't been

too bad. There was a fear going into this year that the first quarter would see quite a downturn. We haven't seen that yet.

For Europe, we've only had about 20 to 30 percent of market cap reports so far. So, you can't necessarily extrapolate to the whole market cap. But so far, the ones that have reported: industrials, banks, healthcare, luxury goods, which is a big share of the European index, they've all reported very well. So, earnings per share numbers have generally beaten, a little bit, expectations.

But I would say one thing about the first quarter. We had some very big positives. It's difficult to remember, but dial back to the end of last year. At that point, China hadn't reopened. People were still worried about gas prices in Europe being very high. And also, through the first quarter, the US economy generated a million new jobs based on the payrolls' data. All of those things have actually aided the first quarter. China has reopened. Gas prices have come down. You've had a still strong labor market everywhere, really, and the US in particular. So, I think the first quarter has been good. But what worries me a little bit is the second and third quarters will be softer.

Sam Grobart: I do want to narrow in on one sector, and you've referred to it already, which is, of course, the tech companies in the US. What have you seen out of those earnings this season?

Sharon Bell: So, we haven't quite had all the big tech companies report. But so far, so good. Another reason the US market has been holding up reasonably well. Volatility has been on the lower side. The big tech companies are benefiting, it seems, from resiliency in their underlying businesses. And also, investments in new areas like AI. So, generally, the reports so far have been reasonably good by big tech companies. And the big cap companies in Europe too. Both sorts of sets of companies have done well in this results season.

Sam Grobart: Staying on the US for a moment, to what degree are financial markets reacting to the debt limit debate going on in Washington right now?

Sharon Bell: So, it's definitely a topic of conversation amongst all investors. Almost every meeting I go to at the moment with investor clients, they're keen to discuss this

topic. So, it is important. And there's often the parallel often talked about is 2011, where there was a period of time where the debt ceiling extension wasn't passed. And you saw the S&P fall 17 percent. And you saw, in fact, the small cap index, the Russell 2000 go into a bear market, fall more than 20 percent just in a matter of a few weeks. So, it is a risky time. It is a topic of conversation. I think, ultimately, it is expected to get through and pass. Eventually.

Sam Grobart: Last question. What are you going to be watching for next week?

Sharon Bell: So, I think probably the key thing next week is that we've got some central bank meetings coming up. We have the Fed. We have the ECB. And commentary from those meetings is going to be crucial, particularly given you have this mix of economic data at the moment. We have growth slowing, but still quite high in sticky inflation. So, what's the Fed going to do? What's the ECB going to do? We are expecting quarter point rate hikes.

I think in the case of the ECB, there is a possibility that the ECB does a little bit more, or at least indicates in the

future that they've got more to go. The other data point which I think is quite interesting for next week is the ECB loan officer survey. Normally, this is quite a specialist piece of information. Banks analysts would be interested in. But I think right now, post all the stresses in the US banks, post the take over of Credit Suisse, it will be interesting to see whether European banks are still extending their loan books, or whether they're drawing back on that lending.

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

Sharon Bell: Thank you.

Sam Grobart: That does it for another episode of The Markets, a new series from Goldman Sachs Exchanges. Follow our brand-new podcast feed The Markets on Apple, Spotify, or wherever you get your podcasts. I'm Sam Grobart. Thanks for listening.

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