

The March Outlook

Market stance

TRUMP

For multi-asset portfolios, we prefer a lower level of equity exposure, equity protection in portfolios and higher levels of cash

Commentary

- The Trump administration's policies are creating a less stable macroeconomic and corporate environment
- Policies are possibly 'stagflationary'

Upshot

- There is increasing evidence of a slowdown in growth and increasing inflationary pressures

EQUITY MARKETS

A number of factors support a cautious stance

Commentary

- Global equity valuations are somewhat less extended than they have been but are still higher on average than is sustainable
- US growth is now slowing and weak conditions still prevail in Europe and China

Upshot

- While valuations have moderated, conditions are not conducive to sustained robust corporate earnings growth

FIXED INCOME

Intermediate, rather than long-dated maturities, continue to be the 'sweet spot'

Commentary

- Short-term inflation risks are increasingly reflected in pricing, but less so for longer-dated maturities
- Conversely, we are sceptical around longer duration securities given the fiscal risks in many countries
- At the same time, the sell-off in high quality European securities is creating some potential buying opportunities

Upshot

- Slower growth may allow central banks to lower rates this year, although it is unclear whether inflationary pressures will allow this

COMMODITIES

Precious metals remain attractive

Commentary

- Gold in particular continues to perform well
- Energy, industrial and agricultural prices have been weaker

Upshot

- Gold continues to benefit as a safe haven asset given increased global risks and from significant central bank purchases

The Long Read

European equity outperformance in 2025 – a blip or a trend?

European equities delivered double-digit returns so far this year, significantly outperforming their US counterparts in reversal of a sustained trend. Despite being an indication of weak US equity performance rather than European strength, there is potential for this outperformance to persist. With that in mind, Saranac equity portfolios have a moderate tilt towards Europe although the US remains the largest investment market by some margin. Our tilt is motivated by stock-specific considerations, with an underweight focused on US megacap companies.

Why European equity has underperformed:

1. Europe's working age population has barely grown in 20 years in stark contrast to the US
2. Productivity growth in Europe has grown by around 10% in two decades, significantly underperforming the US (c.40%)
3. A lack of funding for young businesses in a market dominated by risk averse corporate banks
4. Europe's single market has failings which don't exist between US states

Why the recent bounce could be sustainable:

1. US policy uncertainty
2. Lower comparative European valuations
3. High level of US stock specific risks
4. Widespread European underweight positioning amongst investors

Why has European equity underperformed over the long run?

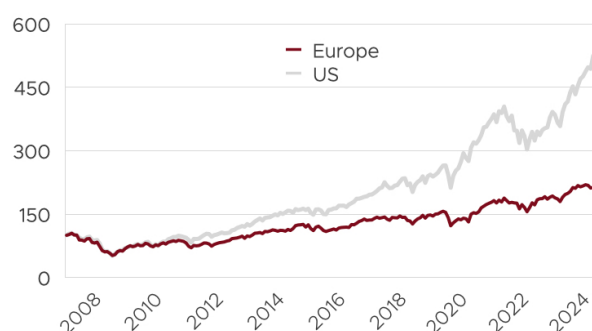
European equities have systematically underperformed their US counterparts for virtually two decades (chart 1). This has become a generational issue.

Professional investors under the age of 40 have not experienced an extended period in which US equities have not been the dominant source of return in a global equity portfolio.

This sustained period of US exceptionalism has led to a US market weight in global equities of ~70%, which is over four times Europe's aggregate equity market capitalisation. Gone are the days when global investors would have exposure to the larger individual European markets as a matter of necessity. Only one European stock is now ranked in the global top 30 by value, and even then, that stock is less than 10% of the value of the three largest firms, which are all from the US.

CHART 1

European and US Equity Performance



Source: Bloomberg, Saranac.

A widely-accepted narrative concerning the causes of European underperformance has been built up, which is no less wrong for being a consensus view.

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At a very fundamental level, US economic performance has been far superior to Europe's, with a range of structural features in play. For one, Europe's working age population has barely grown in twenty years, and is set to contract in the coming decade. The equivalent US population, on the contrary, has expanded by almost 10% over the same period, and is set to continue growing. Additionally, European productivity has risen by only some 10% in the past twenty years, and has been basically flat for almost five years, while US productivity has risen by some 40% in two decades with recent signs that this underlying rate may even be accelerating. If there is an AI 'revolution', any benefits may (for now) be most visible in the US.

Probing beneath the surface of these aggregate numbers also reveals some important microeconomic differentiators. The US has been highly successful in developing small companies into globally dominant firms. In part this reflects a greater willingness in the US to invest in riskier projects, facilitated by liquid capital markets, including in venture capital. By contrast, risk-averse banks dominate European corporate funding, leaving Europe with a very long tail of very small firms.

At the same time, the apparent success of Europe's single market disguises its manifest failings. The IMF estimates that non-tariff barriers between European countries are still equivalent to a 44% tariff for goods, over three times the level between US states. For European services, the effective tariff rate rises to over 100%. At one stage, the relative success of the German economy provided important ballast for the European economy, but Germany too has recently delivered sclerotic rates of growth, as its previous model of leveraging of cheap energy and strong exports to China has proved unsustainable.

Breaking down European underperformance

European equities have not been a poor investment in absolute terms in the past decade. Their return of 6.4% per annum is well ahead of inflation at around 2.5%. It is a higher-yielding market and has returned more in dividends than the US. However, US equity returns have been virtually double. Faster earnings growth and significant re-rating given to the US equity market have swamped European equity performance.

Longer-term negative trends have persisted over time. European equities have continued to underperform the US (chart 2); European profits growth has continued to weaken relative to the US (chart 3); and Europe has failed to benefit from a re-rating of equities similar to that in the US (chart 4). On the contrary, the European equity multiple is still somewhat below its level of a decade ago, despite a significant re-rating in the past couple of years. Table 1 summarises these effects.

CHART 2

US and European Equity Relative Performance: Last Ten Years



Source: Bloomberg, Saranac.

CHART 3

European Profits Growth Relative to the US

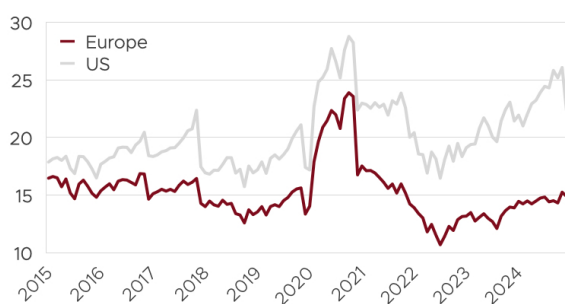


Source: Bloomberg, Saranac.

The Long Read

CHART 4

PE Multiple on US and European Equities



Source: Bloomberg, Saranac.

TABLE 1

US and European Equity Returns 2015-2025

	Europe	US
Total Return	84%	225%
Dividends	49%	38%
Price	35%	187%
o/ Earnings	44%	98%
Change in multiple	-6%	44%

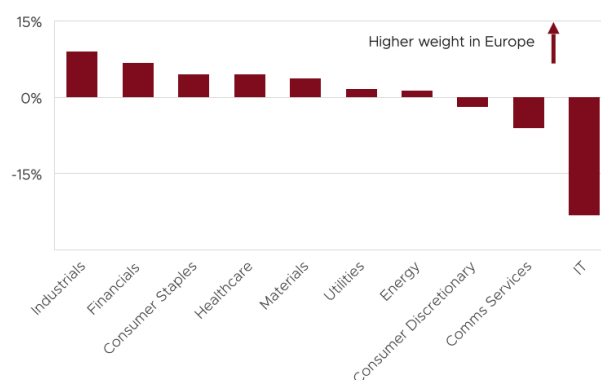
Source: Bloomberg, Saranac.

Sector structure has driven periods of outperformance

As we saw in 2022/23, there have been short-lived periods when European equities have outperformed the US. Usually the different sector structures between both markets have driven these periods of outperformance. Chart 5 shows that Europe has relatively higher weightings in 'traditional' and more cyclical sectors such as industrials, financials and materials. The US has a much larger IT sector, and a higher weight in communication services. This means that when there is an inflationary shock, Europe has tended to have more of a tailwind supporting performance. For example, IT was a material underperformer in 2022 when inflation rose significantly. Indeed, one reason for its long-term underperformance has been the extended period of global disinflation up to 2022, with the associated lower bond yields supporting growth stocks over value.

CHART 5

Relative Sector Weights in Europe and US



Source: Bloomberg, Saranac.

However, the lesson from these past episodes of European equity outperformance has been to regard them as transitory, not trend-changing. Portfolio managers who made large and sustained bets against US equities over the past two decades will have run fairly quickly into a significant wall of underperformance.

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Is the recent bounce sustainable? Four reasons support it.

On this basis, it would appear hopeful to suggest that this year's outperformance of European equities over the US is anything other than a temporary counter-trend reversal (chart 6). Since the end of 2024, European equities are up some 10% compared to 2% for US equities. European equities have also outperformed Japanese and emerging market equities. To a material extent, this outperformance appears to reflect developments in the US. The 'magnificent 7' megacap stocks have fallen by some 15% from their peak (chart 7), retracing much of their post-Presidential election gains. Interestingly, there has been little contagion from this in Europe, where two of the strongest sectors this year have been IT (up to end-Feb) and communications services. These have been amongst the weakest performers in the US market, and strong financials in Europe have also supported relative performance (chart 8).

While all this amounts to a rebound in value as a style, this is far from being a fully-fledged value revival: many of the more cyclical value sectors have underperformed, albeit not by a large amount.

CHART 6

European Equity Performance Relative to the US Rebounds



Source: Bloomberg, Saranac.

CHART 7

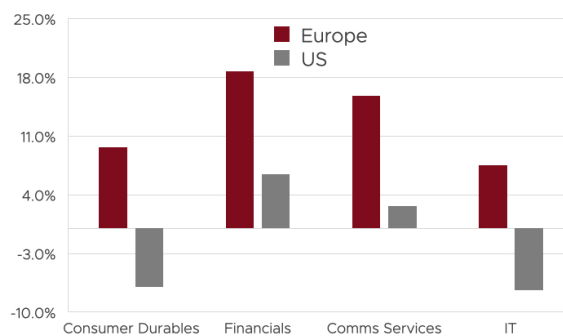
US 'Magnificent 7' Equity Performance



Source: Bloomberg, Saranac.

CHART 8

Relative performance by sector 2025 YTD



Source: Bloomberg, Saranac.

Of course, this may once again be no more than a temporary correction to US outperformance, but there are reasons to probe this issue more diligently than in the past.

First, policy uncertainty associated with the new US Administration is very high, with an increasing risk of macro policies (tariffs, labour force repatriation, compromising Fed independence, fiscal stimulus) having a stagflationary impact. Additionally, the US might weaken the secure legal infrastructure needed for long-term business success. There are some tentative signs that these influences may already be

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starting to undermine US business and consumer confidence, turning a moderately favourable US cyclical background into a more challenging one. This would be problematic for all global equity markets, but more so for those firms closer to the epicentre. Particular challenges arise here because recent consensus thought that a deregulatory environment under Trump could provide the background for a sustained bull market in US equities. If significant positions were taken on this basis, then there is scope for an unwinding of positions if a less palatable environment were to emerge.

Second, the valuation gap between US and European equities has, as noted above, widened significantly, and in a historic context is unusually wide. This has supported US outperformance to date, but it could be a more negative influence going forward. We do not regard US valuations as being 'bubble-like', as the excess valuations are largely concentrated in the megacap stocks, despite the recent correction.

However, while the earnings growth required for these valuations to be sustained is plausible, it is not inevitable, and at high valuations there is far less of a cushion to protect against disappointments than was the case even a year or so ago. Valuation signals in isolation rarely signal a secular change, and the sector composition of the US and European markets need to be taken into account. In some respects, Europe does not offer a haven of widespread low valuations. The sectors with elevated valuations in the US also have elevated valuations in Europe. This is apparent in particular in IT (Europe 30x vs US 35x), communication services (18x vs 21x), industrials (21x vs 26x) and materials (19x vs 23x). However, all US sectors are on higher multiples than their European counterparts, and these valuation gaps are particularly significant in financials, utilities and consumer discretionary.

Third, there is a high level of stock specific risk associated with the market cap weights of US megacap stocks. Even in the broad global equity indexes, the 'magnificent 7' still account for over 20% of global market capitalisation, and that represents significant concentration risk even if these stocks were to be held only at their index weights.

Fourth, in our view many global equity investors are generally under-invested in Europe and potentially over-invested in the US, its high weight in global indexes notwithstanding. Therefore, some scope exists for adjustments in positioning.

Positioning in Saranac global equity portfolios

In Saranac equity portfolios, there is a moderate tilt away from the US towards Europe, with the underweight focused on the US megacap companies. The US market is still, however, the largest investment by some margin. This tilt towards Europe is motivated largely by stock-specific reasons rather than top-down influences. It is designed to be a helpful adjustment to where risk is taken and is not a large bet against the US market as all of Europe's longer-term stresses described above remain in place. The larger economies remain close to recession, even if growth surprises year to date in Europe have been slightly positive, and the ECB's stance is becoming slightly looser.

Given the significant uncertainty associated with the new US administration's policies (acknowledging that positive outcomes are still feasible), and the potential for Europe to face significant headwinds arising from, for example, disorder associated with the war in Ukraine, it is unwise to take significant investment risks based on unclear political predictions.

We have no conviction that European fundamentals have begun to improve significantly, rather, we acknowledge the risk of the fundamentals in the richly-priced and possibly over-owned US equity market may now be deteriorating.

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