Research @ Citi Podcast, Episode 35: European Equities — What's the Next Trade?

Recorded: May 19, 2025

Published: May 28, 2025

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Transcript:

Beata Manthey (00:03)

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Elise Badoy (00:28)

Welcome to the Research @ Citi Podcast. I'm your host, Elise Badoy, Head of Europe, UK, Middle East and Africa Research. And I'm joined today by Beata Manthey in London, who heads up European Equity Strategy. Beata, there's been a lot of attention around the upgrade of Europe to Overweight late last year in 2024. Europe is now up almost 10% year to date while the U.S. is flat. So what's next for the European trade is really the question. And to start with, let's have you, Beata, tell us your high— give us like a high-level summary of your views on Europe, you know, what has changed essentially in the last few months.

Beata Manthey (00:03)

Thanks, Elise. What a ride it's been for Europe this year, right? From the most unloved of global equities late last year to the most wanted for really most of this year. So when we've upgraded Europe in the fourth quarter last year, we were calling back, back then for peak bearishness and some marginal improvements in the outlook, and of course, plus the need to diversify from the very invested U.S. equities. And back then, due to how much it's been beaten up, Europe looked like the most interesting alternative. That has played out. But since then, we got two huge stimulus packages from Europe, risks of global recession via tariffs, and, of course, more cracks in this U.S. exceptionalism. So bottom line, we continue to be Overweight Europe in our global allocation. But right now for different and more structural reasons that we were initially when we've upgraded it more for tactical reasons on their own.

Elise Badoy (02:19)

And I think Beata— we've been on the road together, can you just tell us about the sentiment and flows? What is— you know, what are the latest dynamics for European equities? Does American exceptionalism still fit into it?

Beata Manthey (02:33)

Yeah, that's a good one. And flows and positioning is a very important and interesting perspective. I got to say, we don't get too much pushback in terms of the need for diversification. And you can see that in the fund flows into Europe this year. So I'm sure you've seen these big headlines of inflows into Europe coming back. So to put it for you into the numbers, we've seen about $26 billion of inflows into European equity funds — that's year to date — that translates into around 2% of assets under management. And compared to the total equity— European equity fund outflows that we've been seeing since the Ukrainian war has started, so since 2022, which has been around 16% worth of outflows of assets under management. So the recent inflows have only reversed 10% of these previous outflows, so only starting. Now, who is buying? Everyone has been buying, but more importantly, the U.S. investors have started to come back. And for me, they really represent the ultimate marginal buyer of European equities. And when they come back, this tends to be a very good lead indicator for future performance of Europe. But that's of course just the European side of the flows and positioning story. And you've asked about the U.S. exceptionalism, which is still, in our view, reflected in the long-term buildup of positions and flows from international, so non-U.S. investors. So one of the themes for this year has been and will continue to be, in our view, the need for diversification from the U.S. — let's not go as far as cracks in the exceptionalism — but looking at this from the flows perspective, if indeed international investors are going to start diversifying again, we have hardly seen it in the flows and long-term allocations. So for me, the bottom line for flows into Europe and sentiment is that this could be only starting and continuing.

Elise Badoy (04:58)

Thanks, Beata. We are roughly halfway through the 90-day “pause”. Can you talk to us about tariff risk and what that could do to the European economy and corporates and ultimately how this would feed to the equity market impact?

Beata Manthey (05:17)

Of course. So after the initial announcement of the 90-day pause in the Liberation Day tariffs, the Trump's administration stance on trade has seemingly continued to moderate. So we have continuation of moderation in the rhetoric coming from the White House on that part of the policy. Now, of course, with the U.S.–China tensions de-escalating, that means recession odds are falling. It is plausible to assume that we may have moved past the peak uncertainty from that point of view. Now, the risks, of course, are still there, but it's fair to say that they have decreased, right? But let's step back into the risks, and let me translate these tariff risks into the EPS risks for Europe. So our models have been suggesting 10%, which for a long time we thought would be the base case, would lower European EPS by around 3%. Now, 20%, as announced on Liberation Day, would have been a completely different game, and this is where the impact becomes more nonlinear. And in that scenario, which risk European EPS, basically, European EPS growth being wiped out and going to zero for this year. Now, of course, different sectors have different sensitivities to these risks with Autos being at the top of the risk scale, followed by Basic Resources, Tech is there as well. So these are the sectors that potentially could have been most negatively impacted. Now, interestingly, at the lows of the market correction, our proprietary What’s Priced In for EPS model has been suggesting that flat EPS has been priced in by the market. So at the current levels, of course, with the market moving a bit higher since the lows, the European market is pricing in around 3–4% EPS growth over the next 12 months, and that's still a few percentage points below the consensus analyst forecast, which to me is allowing for some small buffer for further downgrades — not big downgrades, but a bit more of slowdown in the analyst numbers is still in the price.

Elise Badoy (07:49)

But, Beata, we see there's a range of option for Europe to respond to these risks, you know, be it tariffs, security, or others. How can, you know, this help to, in a way, make Europe great again, and, you know, how should investors look at these range of options and the varying impact it may have on markets?

Beata Manthey (08:11)

Absolutely. So, of course, tariff risks are very meaningful risks to the growth, but they come against the backdrop of these any, we have to call them seismic policy shifts in Europe that could ultimately alter the region's economic trajectory going forward. So according to our top-down models, higher defense and infrastructure spend out of Germany — so the broader defense spend in Europe and infrastructure spend in Germany — could boost European earnings growth by around additional three percentage points per annum over the next five years. So that's meaningful, right? We estimate that 1% in the long-term forward EPS growth could be associated with 0.5 higher forward P/E multiples. So historically, higher EPS growth means higher P/E. So the stimulus on its own, when we translate it into multipliers, the translation of the multipliers into additional GDP growth, which by the way, it was always going to be backloaded, so we wouldn't have the— see the effects of it not at all this year, marginally next year. It would only kick in from 2027 in full. These on their own would imply around 1.5 P/E point higher valuations for Europe. And, of course, as Europe is a cyclical market, tends to carry higher ERPs, in a more optimistic scenario, we believe that we could have another contraction in ERP going forward, adding to another half a P/E point of the multiple expansion. So overall, the scale of the stimulus and its impact on GDP and EPS could add two points higher P/E to Europe over the longer term.

So you would ask, what are the takeaways inside the Europe? So first of all, let me start to— again to emphasize the long-term case for Europe, especially so that the stimulus on its own could mean Europe could continue to outperform, especially if the market attracts the equity market inflows as we just discussed, right? And what is very important that that could transform Europe from being just a trade in investors' mindset, as has been the case in the post-GFC world to a much more attractive long-term asset allocation proposition. So that's crucial, right? The stimulus is uncapping growth that— in Europe that, of course, has been the problem in the post-GFC world. And finally, if you think rerating story, what kind of parts of the market should be benefiting from that rerating over longer term? Of course, first part is cyclicals over defensives, then the second, it would be value over growth. And third, going into size, it would be more mid caps over large caps, given they are more domestically exposed and everything that is coming out of that stimulus is going to go into the domestic growth.

Elise Badoy (11:32)

I mean, if we look more towards micro now, you have published this interesting piece of research showing your earnings revision indices, otherwise known as ERI, at peak bearishness recently in various regions. That includes Europe, if I'm not mistaken. So can you talk about this and what it could mean going forward?

Beata Manthey (11:54)

Absolutely. So it was just weeks ago that Europe — not only Europe, as I said, it was downgrades throughout the world with almost no sectors being spared. We've seen this recessionary level of earnings revisions. And well, of course, perhaps not surprisingly, given the heightened macro policy uncertainty that we've been experiencing. Now, –60, this is the reading we've hit four weeks ago. That's only happened 2% of the time historically. That's very rare, and that's a proper recessionary-level readings, right? So what does this –60 mean? So the calculation is the number of up revisions minus the number of down revisions divided by the summation of both. So basically, it's telling you that for every ten estimates changed, you got eight downgrades and two upgrades. That's a lot of downgrades, right? And back then, we've been calling for peak earnings uncertainty being hit back then. Since the –60 was hit, the downgrades have moderated substantially. They are still negative but becoming less negative, therefore suggesting peak uncertainty is behind us.

Now, what do these negative earnings revisions or recessionary level of earnings revisions mean? Well, we've been flagging for the past few weeks to investors that they tend to be a good contrary and buy signal for European equities and European cyclicals in particular. So despite the downside risks to EPS going forward, at these levels of negativity on earnings revisions, on ERI, the future weakness in fundamentals is already— is very often already discounted, and European equities performance-wise from these levels of negativity tend to be 10% higher 12 months out with cyclicals actually being 20% higher. Now, of course, given how much the market has moved since, the question we are getting is: Well, is it over? Is it done? And is there any beaten-up cyclicality, is there any of that left? So our model suggests that, yes, of course, cyclicals have moved very fast with beaten-up cyclicality being less beaten up. But if we had to rank by still the most beaten-up cyclicals, those that screen high are Basic Resources, Autos, Real Estate is still there as well. And what is interesting, Elise, the sector that is most beaten up both in terms of price and valuation discount is Healthcare.

Elise Badoy (14:43)

So, Beata, we're waiting till the end of this podcast, we really would love to hear, you know, your key targets, you know, if you can just summarize it all up for our listeners.

Beata Manthey (14:55)

So, first of all, we do think that trading conditions could remain choppy. It's still elevated policy and macro uncertainty, right? We are not out of the woods there. Now, our longstanding Stoxx 600 price target implies upside to the end of this year. Key downside risk to that would be further downgrades to consensus EPS forecast. However, if we are already moving past the peak uncertainty here, this could set the stage for additional upside potential and even multi— if you want to be more optimistic, potential multiple rerating, especially among these— some beaten-up cyclical sectors that are still left, right? So longer-term prospects for Europe and its place in the asset allocation have definitely improved going forward, and if we avoid the risks of recession from the U.S., and therefore globally, we see the environment where investors could be still adding up to Europe and adding to Europe, especially via the cyclical part of it.

Elise Badoy (16:05)

Thank you very much, Beata. This episode of Research @ Citi was recorded on Monday, May 19th, 2025. I'm your host, Elise Badoy. Join us next time as we discuss the Napa Conference with our head of banking [research], Keith Horowitz.

[Disclaimer] (16:21)

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