EQUITIESFIRST
Progressive Capital
20 YEAR ANNIVERSARY
Institutional Investor

European Equity Markets

European Investors' Near-Term and Mid-Term Outlook Amid Inflation, Rising Rates, Global Conflict, and Pandemic Recovery

Contents

Executive Summary

After three years of pandemic-driven disruption, the global economy and its equity markets are poised for a return to some form of normalcy. Shocks in 2022 – notably, Russia's invasion of Ukraine, the prospect of conflict between China and Taiwan, higher energy prices, supply chain disruptions, and the highest inflation in a generation – led to steep declines in equities around the world. Now, as monetary authorities in developed markets move aggressively to tame inflation amid the risk of a banking crisis in the U.S., the path forward from recent economic crises is coming into focus. In such a climate, equity investors focused on emerging and developed Europe have an opportunity to reassess their strategies and reconsider how they will invest over the near term.

With this in mind, Institutional Investor's Custom Research Lab and EquitiesFirst conducted this study among investment decision makers at foundations, pensions, endowments, and asset management firms to gauge their outlook for equities over the next two years. This report examines the findings among investors that focus on the developed markets of Europe – that is, the United Kingdom, Ireland, Germany, France, the Netherlands, Switzerland, and Austria, among others – and the emerging markets of the region, which include Poland, Turkey, Greece, Hungary, the Czech Republic, and Russia, among others. Through a survey of 80 CIOs, portfolio managers, and other investment decision makers focused on Europe's equity markets, this study finds:

- **Energy prices, interest rates, inflation, and trade relations are top of mind among investors in European equities.** Investors focused on Europe are especially concerned with the cost and availability of energy, rising interest rates, inflation, and trade relationships between countries. Their anxiety about energy costs is tied to Russia's war on Ukraine, and investors in Europe's equities are concerned about the trajectory and timing of tighter monetary policy led by the U.S. Federal Reserve and other central banks in developed markets. Higher interest rates are intended to cool the economy and increase unemployment – but ideally only enough to control inflation. These efforts, say investors, cast a long shadow over national economies and their equity markets and are consistently top of mind as investors assess equity opportunities in Europe.

- **War in Europe, climate change, and cyber-attacks weigh heavily on investors in European equities.** Geopolitical risks tied to the war in Ukraine, global climate change, and cyber-lawlessness sponsored by governments or private enterprises are cited most often by study participants as the geopolitical issues with most immediate bearing on European equity markets.

- **Tilted passive strategies in developed Europe; active strategies for emerging markets in Europe.** Investors focused on developed and emerging Europe endorse smart beta strategies in each market; those focused on Europe's emerging markets voice enthusiasm for active strategies in emerging markets in Europe, due largely to their imperfect pricing and opportunities for high growth. Developed markets are often so efficient, say investors, that a hybrid active/passive strategy provides low-cost exposure to the developed markets of Europe.

- **Investors are especially bullish on health care and high-quality technology sectors.** A solid majority of respondents focused on Europe see the health care and information technology sectors as especially sound investments. Real estate and financial services, say sources in the region interviewed for this study, are less appealing due to uncertainty about interest rates and the post-pandemic structure of these industries.

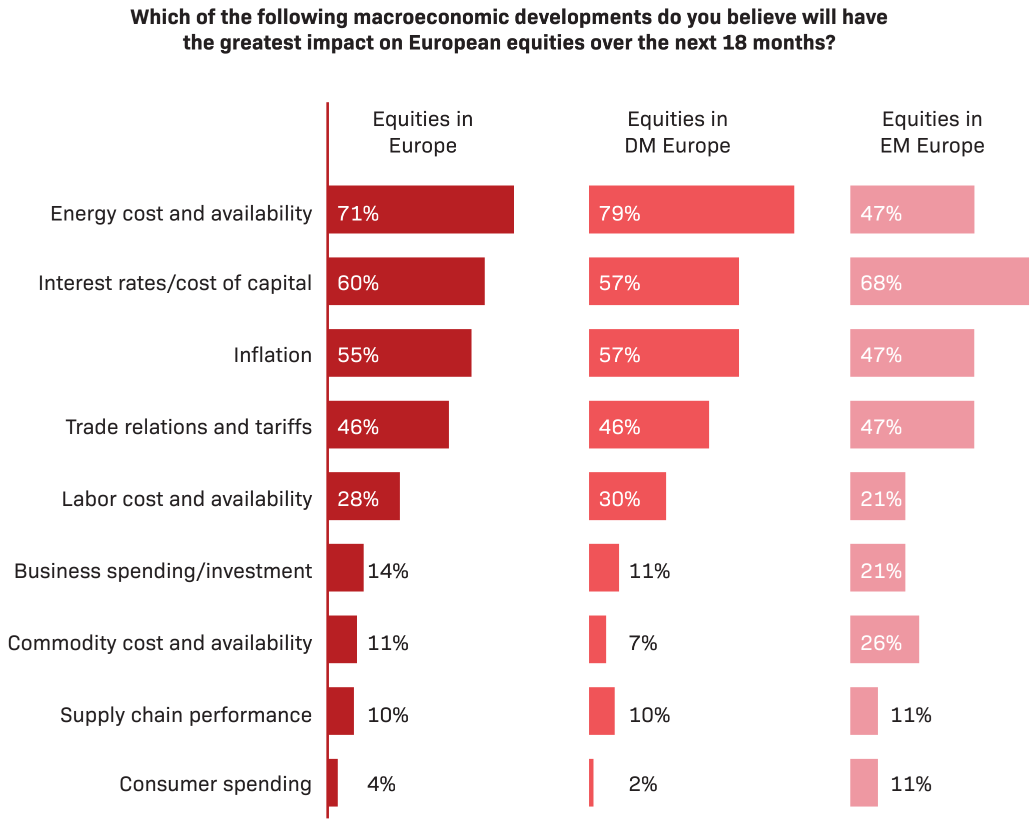
I. As Covid Recedes, Caution Prevails Among Equity Investors focused on Europe

In the first half of 2023, the Covid pandemic has given way to a cautious but sustained return to business as usual. Employees have begun returning to the office. In-person meetings and business travel are increasingly commonplace. Meanwhile, the effects of more than two years of pandemic relief and shocks to the supply chain and labor markets have begun to abate in many economies around the world. Nonetheless, according to this Q1 2023 survey of institutional investors, investment decision makers focused on Europe view equity markets with optimism, tempered by concern about war, climate change, and inflation and their effects on market performance.

ENERGY COSTS, INTEREST RATES, AND INFLATION ARE TOP MACROECONOMIC CONCERNS

A majority of respondents focused on European equities in this study identified the cost and availability of energy, interest rates and the cost of capital, and inflation as the macroeconomic factors that will have the greatest bearing on the region's equity market performance over the next year and a half (see Figure 1). Operating concerns such as trade policy (46%) – that is, the ability to import and export freely and with limited exogenous costs – along with labor cost and availability (28%) were cited most frequently by investors who focus on European equities.

Figure 1. Europe's investors voice concern for energy cost, interest rates, and trade relations



A majority of investors focused on the developed economies of Europe have similar concerns about interest rates (57%) and inflation (57%). However, their greatest anxiety for near-term equity market performance is reserved for energy markets, as nearly eight in ten investors focused on developed Europe say the cost and availability of energy will drive performance of the region's equities. Their concerns are linked to uncertainty about how Russia's war against Ukraine will affect access to natural gas and other hydrocarbons in Europe. The small subset of investors surveyed who follow equities in the emerging economies of Europe see their investment world driven by interest rates (68%) and, to a lesser extent, by trade policy, inflation, and energy costs.

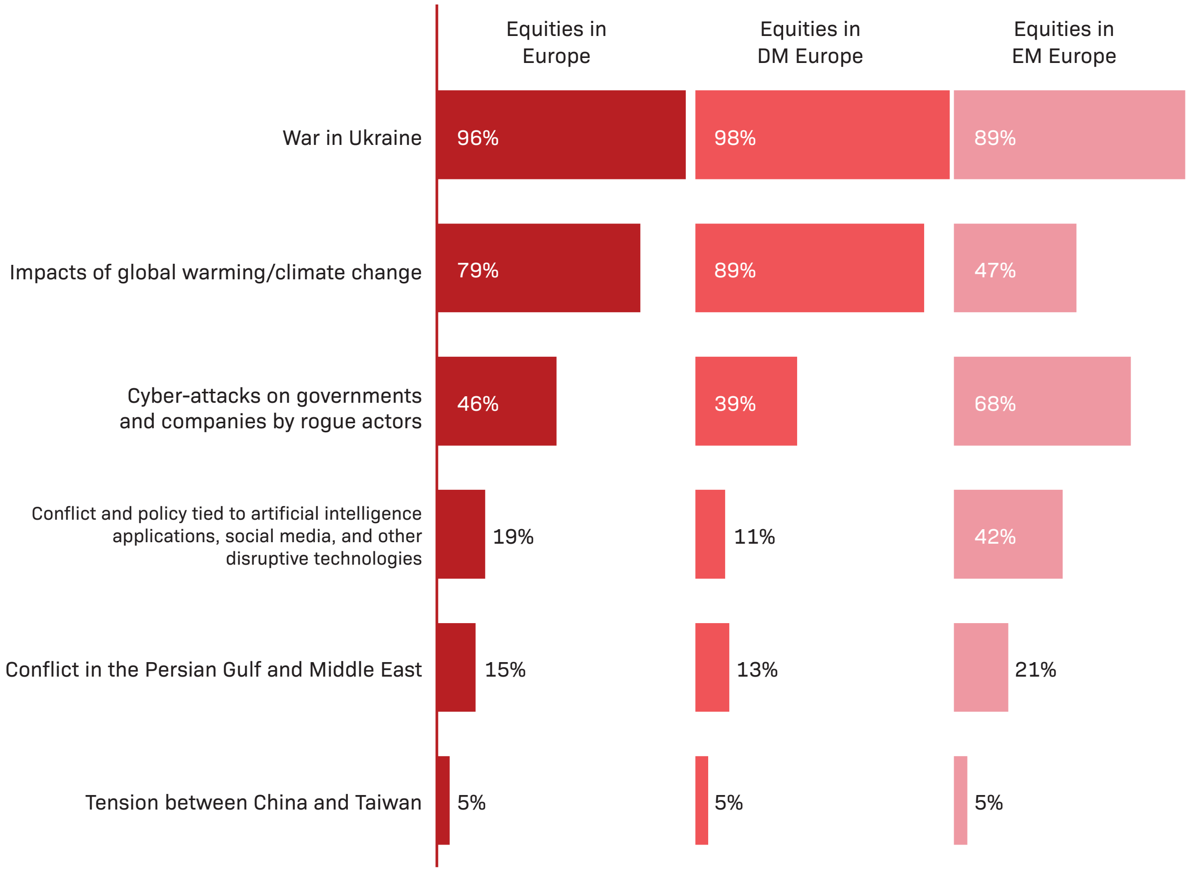
A portfolio manager, who covers global equities at a $3 billion foundation in the United States, sees the nexus of U.S. interest rates, inflation, and the resultant cost of capital as the most pressing unanswered issue looming over equity markets. "All eyes remain on the U.S. Federal Reserve, and Fed policy on interest rates is going to drive equities – up, down, or flat – in most markets over the next few years," he says, "and what the Fed does will in turn be driven by trends in inflation, probably backward looking." The recent increases in interest rates are long overdue, he adds, in part to rein in inflation, but also to restore a sustainable debt market in which investors can earn positive real returns from fixed income investments.

WAR IN EUROPE, CLIMATE CHANGE, AND CYBER RISK TOP GEOPOLITICAL CONCERNS

These pressing macroeconomic factors and the performance of equity markets are influenced by ad hoc geopolitical tensions and disruptions to the orderly course of business. Survey data shows that in aggregate, the vast majority of investors focused on European equities see the war in Europe (96%), climate change (79%), and to a lesser extent rogue cyber-attacks (46%) as the most pressing geopolitical risks to European equity market performance (see Figure 2).

Figure 2. War in Ukraine, climate change, and cyber-attacks weigh heavily on Europe's investors

Which of the following geopolitical developments do you believe will have the greatest impact on European equities over the next 18 months?



The war in Europe weighs heavily on Europe's investors, as 96% of such respondents see it as a material risk to performance. Investors focused on the developed markets of Europe are nearly unanimous in their concern for the war in Ukraine (98%), and almost 90% of such respondents see great impact on the region's equity markets from global warming and climate change. Notably, Europe-focused investors interviewed for this study say that climate change is a source of both downside risk and visible upside opportunity, as companies throughout the developed economies of Europe are taking aggressive steps to transition to sustainable energy sources. Indeed, it is hoped by some investors that developed Europe will emerge with a first-mover advantage as a source of products and services to serve an increasingly environmentally conscious global economy.

More than 45% of equity investors focused on European markets see cyber-attacks on companies and governments by rogue actors as a pressing geopolitical risk. Other risks tied to technology – e.g., advancing artificial intelligence and data privacy concerns tied to social media platforms such as TikTok, among others – are top of mind among nearly one-half of these investors.

Investors see new technology as a source of both downside underperformance and upside gains. "I have no doubt that technology innovation – good, bad, or indifferent – is going to be a major factor in U.S. equities going forward," says a foundation portfolio manager in North America. "Security and cyber-attacks are bigger problems than they may seem, probably because we may not hear about them – or really understand their implications – for a long time." Conversely, he remarks that "things like Chat GPT and AI are both alarming and exciting, and some companies are going to make great businesses out of them."

Investors focused on European equity markets seem eager to harness global climate change for economic benefit. More than three-quarters of these investors see the impact of climate change as having a great impact on the region's equity markets. Much of this anxiety stems directly from the disruption and negative outcomes of rising global temperatures. However, such disruption also brings opportunity to develop valuable solutions to the formidable problems of rising temperatures and sea levels, low-carbon energy transition, and other looming problems associated with climate changes.

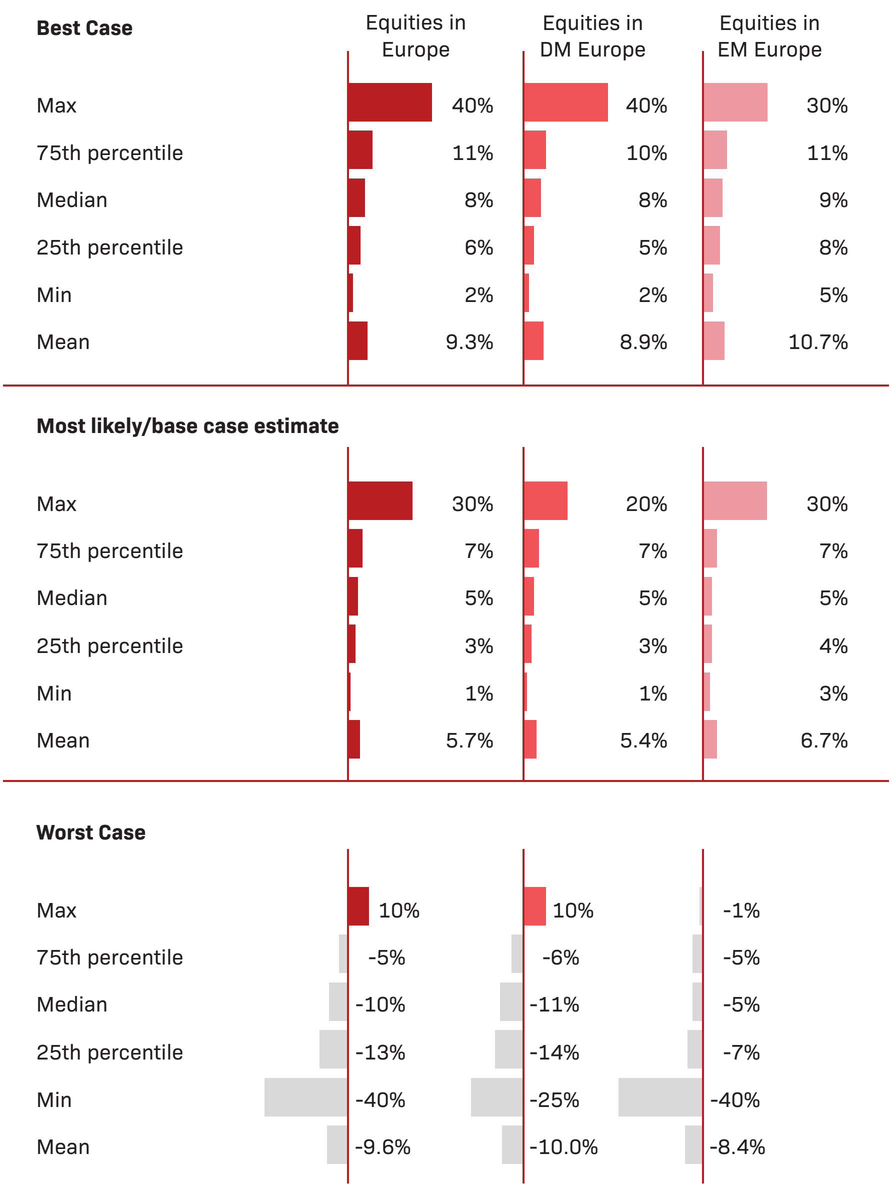
Sources explain their difficulty in integrating long-term geopolitical risk and climate risk into investment decision making. "You can't model climate risk or geopolitical risk because we haven't had it happen exactly the same before," says the head of equities at a pension in Australia. "We haven't got a model into which we can shovel 50 years of inflation numbers and develop a forecast. Why? Because we've never had a climate crisis before." Bearing this in mind, she says, "I think investors react at a micro-level, not a macro-level – that is, they're going to react to individual companies improving their earnings by becoming more sustainable over time, or a successful transition of a company from dirty to clean, or the development of a really innovative offering or management practice. I think that the reaction to the climate crisis will be based on individual company activity and performance rather than anything else."

INVESTORS' OUTLOOK FOR EUROPEAN EQUITY MARKETS

We queried investors on their expectations for the 2023 return on Europe's equity markets. In aggregate, investors focused on the region anticipate equities will deliver a mean return of 5.7% this year, with a mean best-case scenario of 9.3% and a mean worst-case of -9.6% (see Figure 3).

Figure 3. Baseline estimate of European equity returns is 5.7%

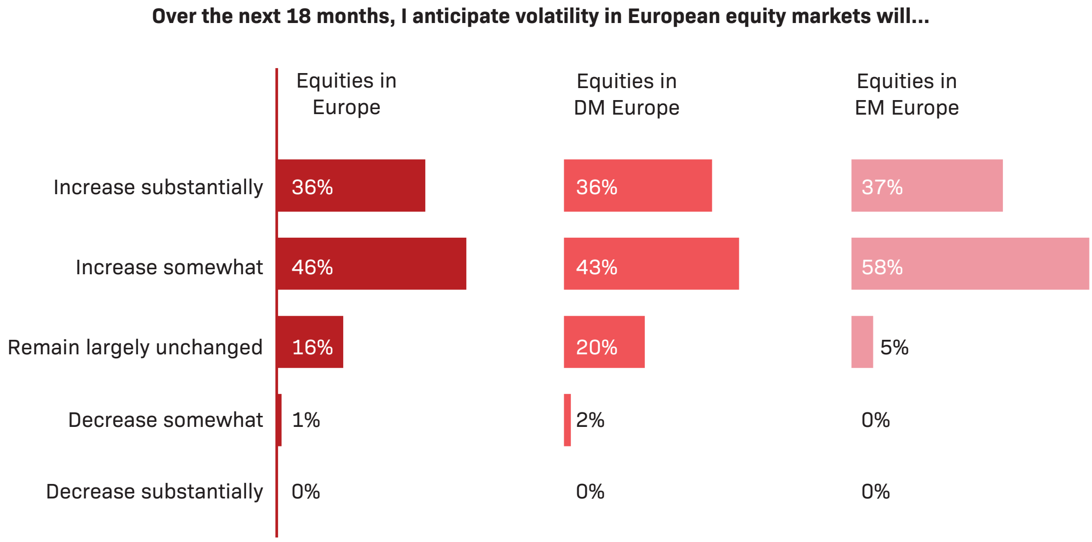
"I expect the return on my market of focus market in 2023 will be..."



Broadly speaking, these estimates should come as welcome news for equity investors across all the regions and markets examined in this study. Compared with last year, equities are forecast to recover some of last year's double-digit downturns and to begin their ascent to their long-term historical averages.

As investors navigate these macroeconomic and geopolitical concerns, they anticipate increasingly volatility equity markets. Nearly 80% of survey respondents focused on developed markets in Europe anticipate increasing volatility, and those focused on emerging Europe are likely to foresee substantially greater volatility in their markets compared to those focused elsewhere (see Figure 4).

Figure 4. Amid concern for cost of capital and political matters, investors expect sustained volatility in equity markets



This market volatility, coupled with uncertainty tied to monetary policy, trade relations, and military conflict, poses risks to economic growth, day-to-day operating activity, and the current value of financial assets. Of course, volatility also offers opportunity to savvy investors who are able to take advantage of the pricing errors and market dynamics that are inherent in volatility markets. Using active strategies that focus on taking positions in mispriced assets, investors and their asset managers are able to outperform market indexes, often yielding handsome abnormal returns.

The question remains, of course, what strategies are most suitable for which markets? Investors interviewed for this report stress that a sound equity strategy begins with a clear sense of the objectives and constraints of a portfolio and its various segments. An insurer, for example, seeks to ensure it has the liquidity to pay near-term claims while putting some assets at higher and longer-term risk in an effort to generate returns for shareholders.

Similarly, a pension must manage its cash flow requirements, funded status, and long-term asset appreciation objectives. A family office may have greater freedom to seek higher returns through unconstrained alpha-seeking strategies. Accordingly, institutional investors operate under complex internal requirements that can limit their return-seeking investments in equity markets. Nonetheless, their experience serves as a valuable guide for other investors who seek to draw on their expertise in equity markets.

II. Equity Strategies for Europe Amid Volatility and Risk

Queried on their two most preferred strategies in equity markets for the next two years, survey respondents focused on Europe equities are most likely to endorse so-called smart beta strategies (a hybrid of broad index strategies that have been tuned to market expectations by over-weighting some assets or investment characteristics and under-weighting others), followed by active quant strategies and fundamental, bottom-up strategies. Fully 70% of survey respondents focused on Europe see such smart beta strategies as a preferred strategy over the next two years (see Figure 5).

ACTIVE VERSUS PASSIVE STRATEGIES

Enthusiasm for smart beta strategies is led by investors focused on developed markets in Europe (72%). But survey data and interviews for this report reveal a decided preference for fundamental, bottom-up active equity strategies in the emerging markets of Europe. Smart beta strategies are especially suitable, say investors, in developed markets due largely to the efficiency and trading volume of these well-developed markets.

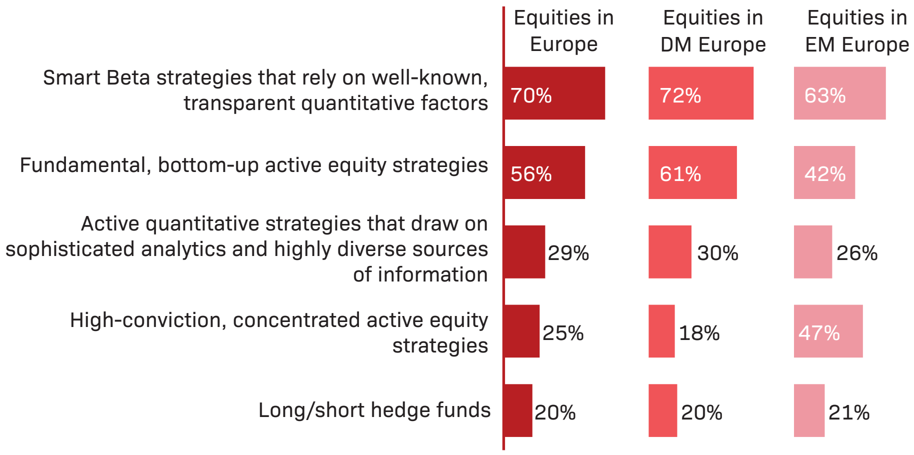
“It’s hard to add value in large-cap equities in developed markets with an active stock picking strategy,” says the North American foundation portfolio manager. “The formula generally for the last ten years has been to invest passively in large-cap equities to keep up with your benchmark and to invest in satellite positions in small caps and especially in emerging markets.”

The returns on riskier emerging markets are higher in aggregate, and with the right strategy, an investor or manager can deliver strong returns with a well-informed active strategy. “Emerging markets are inefficient,” says the portfolio manager, and “you can reliably outperform if you choose the right managers in emerging markets.” He says, “high-conviction managers who focus on more niche areas” as especially good candidates for emerging markets. And, he adds, such active equity strategies are especially valuable now because private markets are over-valued. “Private equity and venture capital have delivered excess in recent years, but it’s hard to get into private markets now because they haven’t corrected in price,” since private assets are not marked-to-market using recent arms-length transaction valuations. Thus, he says, “it’s hard if not impossible to find a good entry point for private markets.”

In the higher risk/return markets of developing Europe, wherein information for investment decision making is at times uneven and trading volume is thin, concentrated high-conviction strategies are more likely to be viewed as highly effective. Indeed, nearly one-half of investors (47%) focused on developing markets select high-conviction strategies as one of their top two strategies for the next two years.

Figure 5. Investors call for factor-based smart beta strategies in developed Europe and research driven, active strategies in emerging Europe

Which two of the following strategies are likely to be most effective in delivering high returns for your institution’s equity allocation over the next two years?

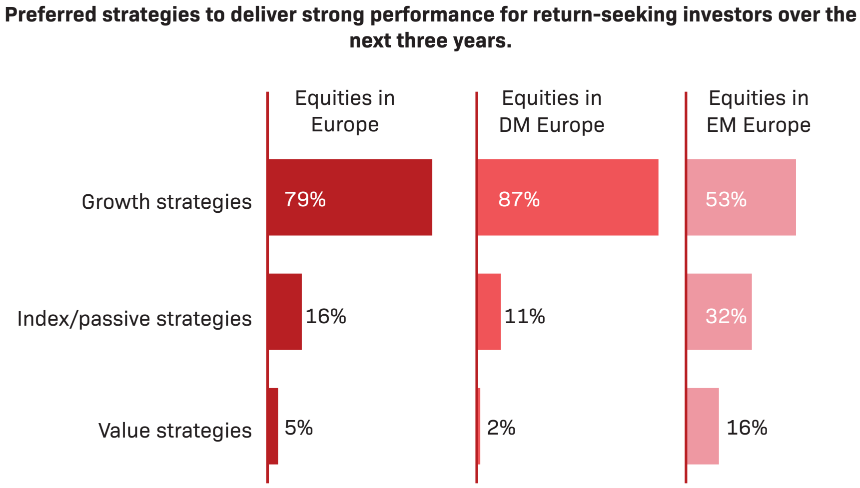


All equity strategies require some form of overarching principle or decision made in advance. Two basic strategies – growth and value – have emerged as guideposts for investment decision making for active equity investments. Value strategies seek out equities that are currently undervalued based on market factors or conditions at a particular company. Such strategies seek to invest in under-performing companies before their operating results and market performance turn more positive. Growth strategies typically seek out issues that are likely to enjoy rapid and often unforeseen increases in revenue, profitability, and market presence.

Investment decision makers voice consistent support for growth strategies over the next two years at the expense of value or index-based passive strategies. Their rationale for doing so may well be tied to optimism about the prospect of a period of sustained economic growth and the emergence of new high-growth companies or offerings from well-established innovators that are well positioned to prosper in the years ahead. Value strategies are more likely to thrive during periods of moderate economic growth and low capital costs, when high-growth opportunities are often elusive and index strategies suffer from the malaise of tepid growth and profitability.

“Remember, value stocks are, by definition, cheap – that’s the whole idea,” says the foundation portfolio manager in New York. “And one reason they’re underpriced is because they’re over-leveraged” with too much debt. In a rising interest rate environment, valuations of debt-laden companies are more likely to be brought down by high interest costs, low profitability, and uneven cash flow. Accordingly, says the portfolio manager, he’s likely to rotate out of value stock positions into higher growth, well-established high-tech and information-intensive companies.

Figure 6. Strong support for growth strategies over value

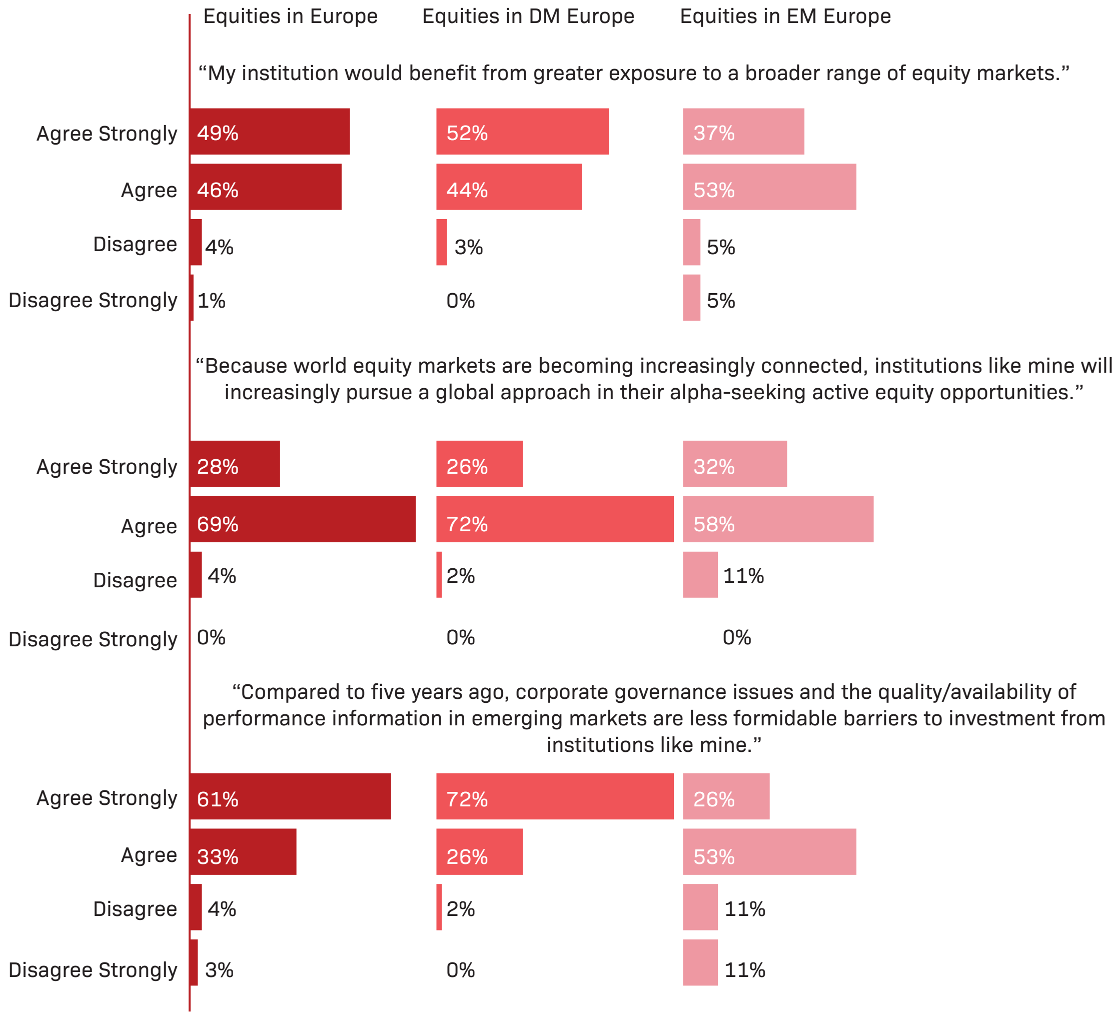


Investors interviewed for this report stress that investing in equity markets is seldom a matter of executing a single strategy. Rather, they favor strategies tuned to the size of the allocation and the availability of sound investment hypotheses that can be tested, executed, and managed prudently. Doing so, say institutional investors, requires access to information that reveals undervalued and high-growth equity opportunities. With these characteristics in mind, we queried investors on their views on sources of high returns for equities.

By a wide margin, investors call for an expanded universe of equity investments. More than 90% of respondents focused on European equities agree that their institutions would be well served by investing more broadly across the world’s equity markets (see Figure 7). Their rationale for doing so stems from the growing interconnectedness of the global economy and its equity markets, according to survey data. The vast majority of Europe’s investors agree that institutions like theirs will pursue global (as opposed to regional) strategies in their alpha-seeking active equity opportunities due to the increased connectedness of global markets.

Figure 7. A broader investment universe garners consistent support across Europe's equity investors

To what extent do you agree with the following statements?



MASTERY OF EMERGING MARKET DYNAMICS

For many investors in developed markets, a broader equity universe implies paying closer attention to opportunities in emerging markets, which are often unfamiliar, illiquid, and geographically and culturally distant from the developed markets on which they focus. Indeed, prevailing in such markets with active strategies requires investors and their managers to master the dynamics of emerging markets and the performance of companies in them.

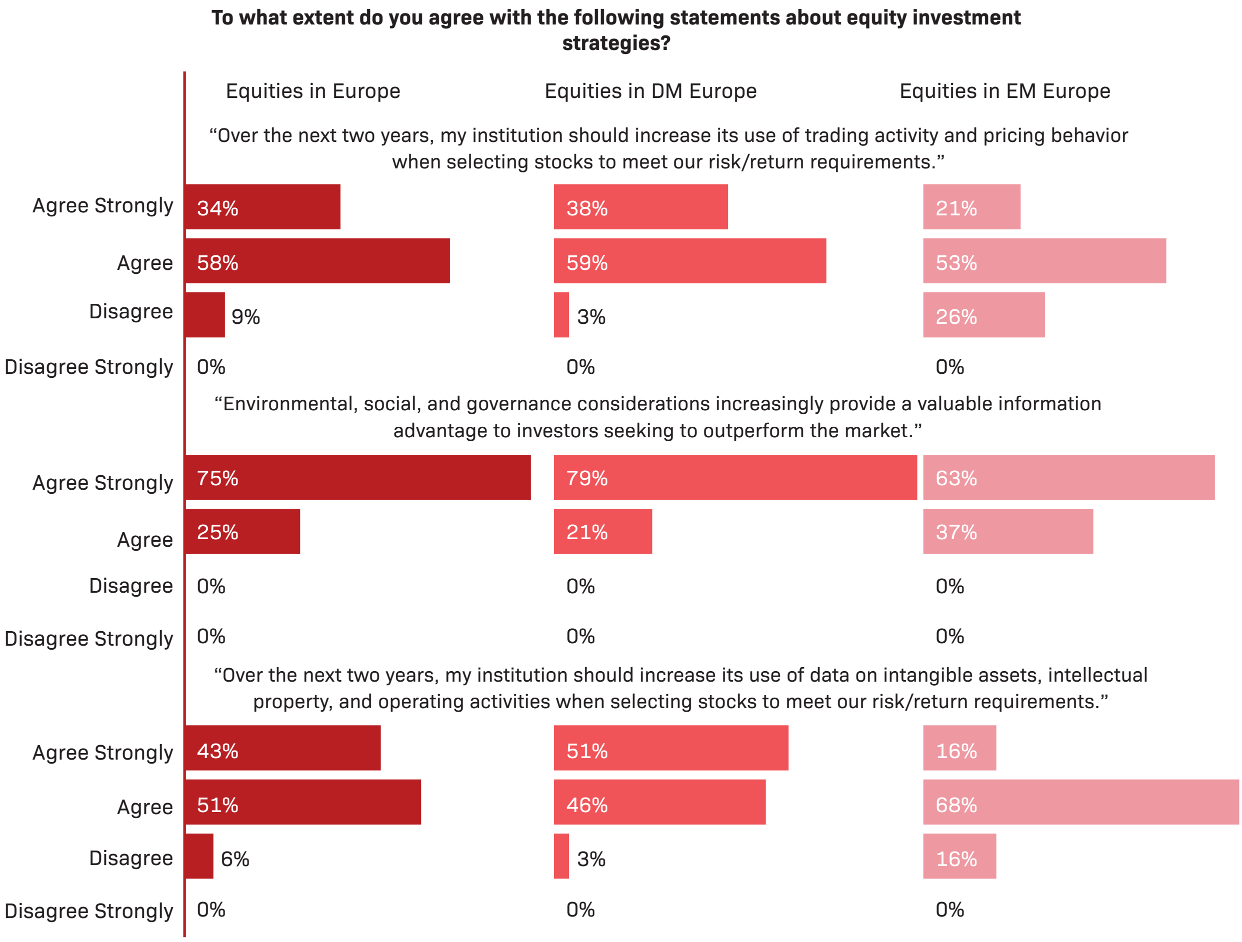
Doing so is no simple task, as emerging markets suffer from uneven, inconsistent reporting and audit standards, and the transparency and corporate governance that investors expect have lagged behind those of more developed markets. Survey data indicates that recent efforts in emerging markets to improve audit standards and corporate governance have progressed well, and with few exceptions, investors believe that corporate governance and information quality have improved over the last five years. Sources interviewed for this study are encouraged about emerging markets and say more improvements are likely in the years ahead, as asset markets become increasingly global and thus compete for investors' capital across national borders and regional segments.

In Hong Kong, the pension equity head says, "Is emerging market reporting and compliance better and improving? Yes, no doubt about it. Is it where it should be? No." She continues, "When I started looking at this five years ago, it was dreadful. Over the years, companies and their advisors are improving their knowledge of sustainability, governance, and reporting." She is reluctant to attribute improvements to any particular shift or mandate. Rather, she says, emerging market companies "have come to realize that they were behind the eight ball and had to make a move toward greater transparency. It's about visibility – if these companies want investors to embrace them, they know they have to meet their reporting and transparency requirements."

Investors' efforts to discern valuable active strategies hinge not only on a broader equity universe and better information for investment decision making, but also on harder hitting, more circumspect analysis of market trading activity, intangible assets and nonfinancial/operating activity, and ESG performance. Queried on their use of market trading data – that is, trading volume, price trends, and correlations with other assets, for example – nearly 40% of Europe's equity investors in this study agree strongly that they should do more to integrate forms of technical analysis in their investment decision making (see Figure 8).

Similarly, more than 40% of survey respondents focused on European equities agree strongly that they should increase their use of data on intangible assets, intellectual property, and operating activities when selecting stocks to meet risk/return requirements. ESG disclosures also emerge in the survey results as an important source of valuable information for investment decision making. A solid majority of investors covering developed markets in Europe say they agree strongly that ESG considerations increasingly provide a valuable information advantage to investors seeking to outperform the market. This affirmation of the value of ESG information serves as a clear indication that companies' efforts to disclose the impact of their operating activities and aspirations for improvement have yielded meaningful information for investors.

Figure 8. Investors seek mastery of nonfinancial data across a broader universe of equity markets



III. Investors' Views of Sector Performance

Survey respondents worldwide seem to be especially bullish on technology and health care sectors over the next few years, largely at the expense of utilities, materials, and communications services firms. A solid majority of investors focused on European equities (68%) in this study are bullish on the health care sector, which includes health care equipment and services, along with biotechnology and pharmaceuticals, and 64% of such investors see notable upside opportunities in the information technology sector.

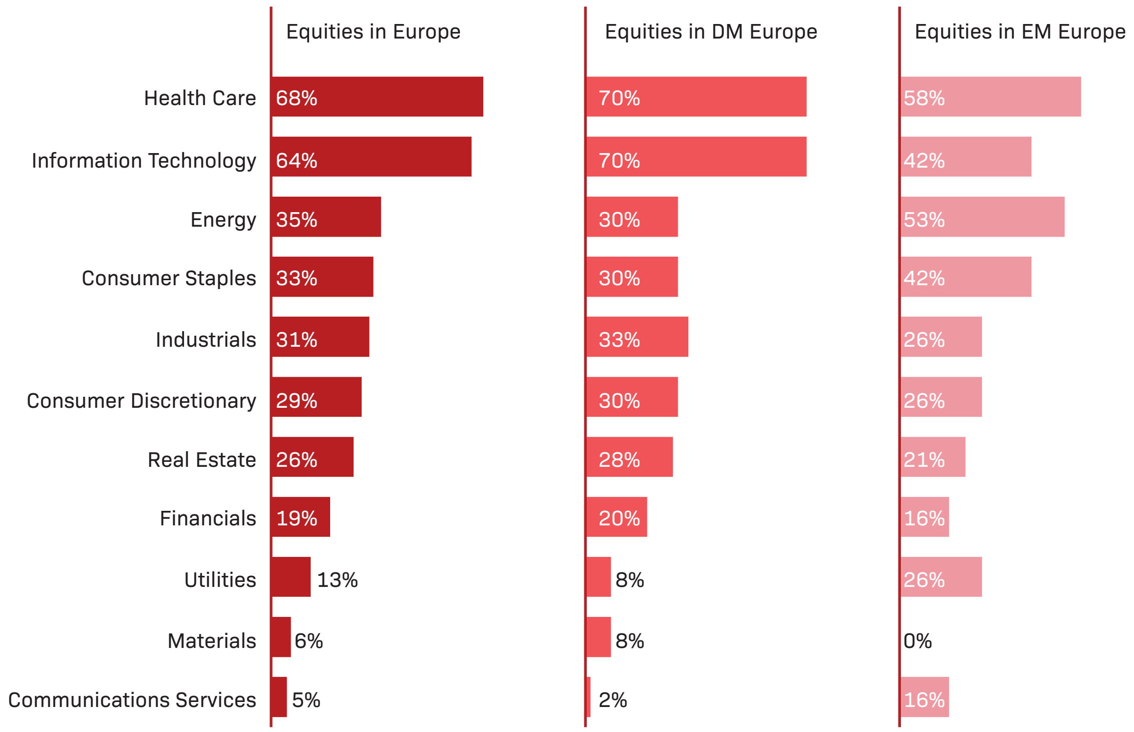
"I think biotech is going to be insulated from the vagaries of the economy, because the FDA will keep approving cancer drugs, and the world's going to keep getting sick," says the foundation portfolio manager in North America. "Big pharma will keep making billions every year, and they'll go out and buy a bunch of small-cap biotech companies. Biotech shares are uncorrelated relatively, so we're pretty bullish on the sector."

Another portfolio manager at a North American foundation sees upside in technology and health care, saying, "I'm most bullish about proven innovators in technology and pharma – those that have a business based on something that has demonstrated market appeal." Similarly, he sees medical and biotech issues as sound bets in the next few years. "Health care in this country is still a complicated industry, and there's a lot of room for innovation – and for pricing errors. Demand isn't going anywhere, so we can be confident that someone's going to win. The question is, who?"

Investors elsewhere concur on the outlook for health care, largely due to both innovation in the sector and the gradual shift toward an older population. "Health care is going to be a big sector because of demographic shifts and expanding access in developing countries. Indeed, some parts of the health care segment are likely to outperform the IT sector," says the equity head from the Australian pension. As economies around the world emerge from the pandemic more fully, she argues that consumer staples, "if they're well made, by well-managed companies, at low cost, then sellers will be able to take advantage of fairly elastic pricing" and prevail in an economic slowdown.

Figure 9. Sector-level outlook is especially strong in health care and technology

Which of the following sectors offer especially strong returns to investors over the next three years?



Less appealing, say investors, are sectors whose performance is linked closely to interest rates and the business cycle of expansion and contraction. Few investors see strong upside in real estate equities or in the financial sector, which is composed of commercial and investment banks, capital markets, and insurance.

Investors say their concern about the real estate sector stems from uncertainty about interest rate changes over the next year, as well as questions about how both the residential and commercial real estate industries will rebound from the pandemic.

IV. The Road Ahead

In many ways, equity investors focused on Europe are in a strong position in 2023. The global pandemic continues to recede after three years of economic disruption. Swift interest rate hikes from developed market central banks demonstrate both the gravity of high inflation and monetary authorities' determination to tame it. Meanwhile, Europe's investors express concern about the war in Ukraine, interest rates and capital costs, trade relations, and other geopolitical matters. Nonetheless, say Europe's investors in this study, equity markets are poised to recover in 2023 from the substantial corrections of 2022. The baseline estimate for equity returns in Europe averages 5.7%, with marginally higher returns expected in the emerging markets of the region.

In this environment of cautious recovery, investors in this study reveal a sense of optimism about investing in equities. While no single approach works in all cases, this study among investment decision makers, who manage an estimated $2.2 trillion in assets, reveals the following:

- Pricing errors and volatility provide opportunities to generate alpha returns from active strategies in European emerging markets.

- Institutional investors see tilted passive strategies as especially sound and cost effective in the highly efficient developed markets of Europe (and elsewhere).

- Investors participating in this study are notably bullish on high-quality technology and health care sectors.

- Real estate and financial services are less appealing due to uncertainty about interest rates and the post-pandemic structure of these industries.

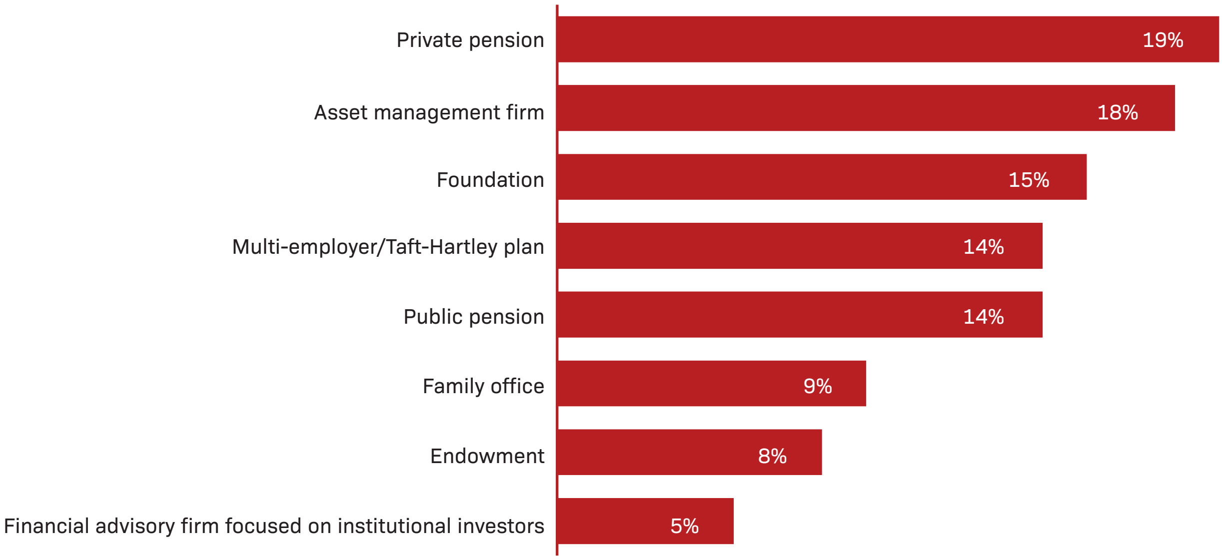
As Europe's investors pursue their investment objectives in the years ahead, the most successful are likely to be guided in their decision making by thoughtful analysis of nonfinancial and ESG information and by the increasingly transparent corporate governance data from companies in emerging markets.

About this research

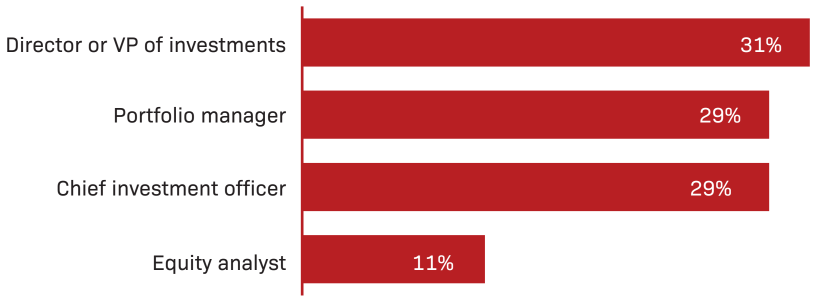
This report examines the views of investment decision makers at asset-owning institutions and asset managers on the outlook for equity markets around the world and the strategies most suitable for investment over the next two years. Institutional Investor's Custom Research Lab composed a questionnaire with the EquitiesFirst and interviewed six well-informed sources at asset management firms, pensions, and insurers. The questionnaire was fielded in February and March 2023 and includes responses from more than 300 investment decision makers at institutions in North America, Europe, and the Asia-Pacific region.

The demographic highlights of the subset of 80 survey respondents focused on European equities are provided below.

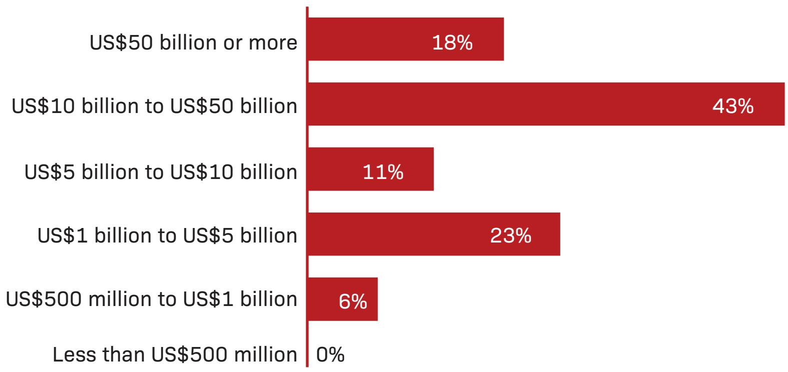
What type of institution do you work for?



What is your title?



What are your institution's assets under management?



Sponsor’s Perspective

Confidence in Uncertain Times

After a series of macroeconomic and geopolitical shocks buffeted global equities in 2022, equity investors are facing an uncertain future. Higher interest rates, persistent inflation, and geopolitical tensions have fundamentally transformed the investment landscape, and volatility has remained a feature of equity markets through the first quarter of 2023.

Against that backdrop, many investors have been tempted to increase their allocations to alternative asset classes, such as private markets, and higher yields support the case for bonds. This report, however, found that investors remain broadly optimistic about equities, with the base case consensus showing a modest recovery in 2023. Over the medium term, investors also indicated their confidence in growth stocks and innovative sectors such as technology and health-care.

These are encouraging findings. As a partner to long-term shareholders and a co-investor alongside our clients, we understand that investor confidence is important to the health and smooth functioning of equity markets, and this research confirms that the world’s leading institutional investors continue to see equities as an attractive asset class – despite the recent challenges.

Finding value in volatility

Investors can take comfort in these findings, but they must also tread carefully. Liquidity is at a premium in times of uncertainty, and we continue to help numerous clients manage their capital requirements as the value of their portfolio changes.

This report confirms that material risks remain elevated: interest rates and inflation top the list of macroeconomic concerns, but geopolitical risks also weigh heavily. Concerns about climate change, the war in Europe and rogue cyber-attacks are also widespread.

These risks will likely continue to drive heightened market volatility, and there can be no guarantee that successful investments in the past will perform well in the future. Yet this kind of uncertainty also creates significant opportunities for investors to outperform the broader markets.

Flexible solutions

In the current environment, securities-backed financing provides a flexible, cost-effective and stable form of capital that allows investors to move quickly into new positions and diversify their portfolios. It also smooths out volatility by allowing investors to monetize their long-term shareholdings and put a floor under valuations.

EquitiesFirst has a 20-year track record in providing such Progressive Capital. As partners to long-term shareholders, we offer low-cost, flexible funding to help investors pursue new opportunities while maintaining the upside potential from their underlying holdings.

While there are simply no clear answers to the big questions facing equity investors – including how long inflation will persist and how far demand will decline in taming it – there will be clear opportunities for those who can act with confidence in uncertain times.

EquitiesFirst remains committed to enabling our partners to do just that through pioneering solutions that transcend the limitations of traditional financing.

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