European equities: What to do next?

Investment strategy insights

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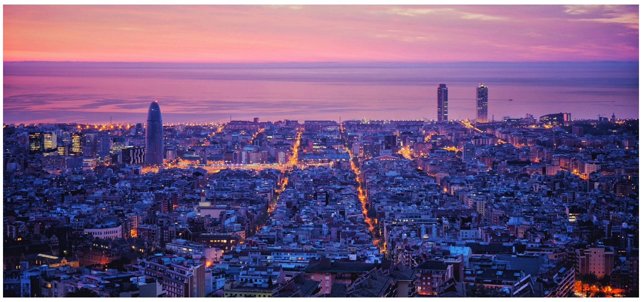
- The potential for the Trump administration to impose reciprocal tariffs on the European Union, with subsequent countermeasures likely, could exacerbate trade tensions, impact European economic growth, and weigh on earnings. Investors have moved to price in more adverse trade scenarios than expected at the turn of the year.
- Despite the fundamental backdrop for European equities remaining positive thanks to pro-growth policies following the German election, a potential peace deal with Ukraine, and a cyclical recovery in manufacturing, we retain a Neutral stance on European equities due to several near-term risks we flesh out below.
- We explain why our intra-market preferences tilt toward segments that are relatively insulated from the threat of trade tariffs, offer exposure to structural growth trends, and can benefit from European monetary and fiscal support. They include industrials, IT, utilities, health care, and real estate. Thematically, we continue to like Eurozone small- and mid-caps and select European exposure via our "Six ways to invest in Europe" portfolio.



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What developments have changed the outlook for European equities?

Recent geopolitical and economic developments have significantly impacted the outlook for European equities, in our view. The looming threat of reciprocal tariffs from the US, set to be decided on 2 April, poses earnings risk for companies exposed to trade and international supply chains. And given the speed of the Trump administration in applying tariffs, markets have quickly moved to price in more adverse trade scenarios than expected at the turn of the year.

While existing European Union (EU) tariffs on trade with the US are relatively low, there is a high chance this changes in the coming weeks. It is impossible to know by how much tariff rates will rise, but we cannot rule out the potential for a 25% tariff on key sectors such as machinery, transport, chemicals, and pharmaceuticals. Such a development could raise the effective tariff rate on EU exports to the US from close to 1% to around 15%. This would likely lead to a similar response from the EU, which has been clear that it would react "firmly and immediately" to any US tariffs, indicating a readiness to impose countermeasures of similar magnitude—as evidenced by the bloc's response to President Trump's tariffs on aluminum and steel. This tit-for-tat approach could exacerbate trade tensions and impact economic growth.

Additionally, the US administration's focus on the EU’s bilateral trade surplus, its level of defense spending versus the US and against NATO commitments, and the imposition of digital services taxes that impact leading US tech firms all add layers of complexity to trade negotiations. The fact that the EU has fewer concessions like reduced narcotics flows or stricter controls on migration to offer as bargaining chips also means the tariff-related risks to both European activity and asset prices are perhaps more persistent and more meaningful than in other markets.

Our modeling suggests that such tariffs could halve the expected Eurozone growth rate in 2025 from around 1%, although this should not trigger a recession. For next year, the impact would likely be less as the economy adjusts, but growth would likely remain below trend. We think tariff impacts would influence growth more than euro area inflation, which we expect to decelerate due to weaker demand and consumer confidence in a more hostile tariff environment. In such a scenario, the European Central Bank (ECB) could be compelled to lower rates below 2%, a level we expect the bank to reach by June.

What's the fundamental backdrop?

Despite the tariff threats, we believe that the fundamental backdrop for European equities remains positive. The region has been supported by several positive drivers, including pro-growth policies following the German election, a potential peace deal with Ukraine, and a cyclical recovery in manufacturing. We expect Germany's fiscal plans (including a proposed EUR 500 billion infrastructure fund and revised borrowing rules) would boost GDP growth in 2025 and 2026. These measures aim to revitalize the economy and enhance defense capabilities, with positive spillovers anticipated across the EU.

Eurozone inflation has been stickier than anticipated and fiscal boosts in Germany and across the euro area could slow the disinflation process, which may slow the pace of the ECB's rate cuts. But our general sense is that European firms, especially smaller ones more reliant on bank funding, may benefit from some further easing in funding costs.

At least part of this positive outlook is already in the price. European equities have outperformed other developed markets year-to-date, driven by optimism around these catalysts. Valuations are reasonable compared to the US market on a sector-adjusted basis (using MSCI index data) and earnings are bottoming, in our view—we forecast 5% earnings per share growth this year for the MSCI EMU Index, accelerating to 8% in 2026. The current corporate results season has seen companies generally reporting ahead of expectations, supporting our view that earnings growth already bottomed and will gradually recover.

So, why is CIO Neutral on European equities?

Despite the positive fundamental backdrop, CIO remains Neutral on European equities due to several near-term risks. The potential for further tariff announcements and economic growth uncertainty could lead to market volatility. While the recently announced German fiscal plans leave Europe better positioned, expectations around catalysts have largely played out, limiting the potential for further positive surprises. We recently closed our tactical recommendation to invest in the DAX via structured strategies on 10 March to reflect these developments.

For investors, the current environment underscores the importance of staying invested to benefit from the medium-term potential gains in European equities. However, it is crucial to consider hedging equity exposures to manage some of the near-term risks.

Our preferences tilt to segments that are relatively insulated from the threat of trade tariffs, offer exposure to structural growth trends, and can benefit from European monetary and fiscal support. This supports our sector preferences for industrials, IT, utilities, health care, and real estate.

Thematically, we continue to like Eurozone small- and mid-caps and select European exposure via our "Six ways to invest in Europe" theme. This approach allows investors to diversify their portfolios across multiple drivers, optimizing the potential risk-return of the portfolio. As Europe emerges from its downturn, we see a cyclical economic recovery on the horizon, supported by disinflation, real wage growth, and more ECB rate cuts.

Another driver is the likely rise in security investments after years of underspending before the Ukraine war. The Munich Security Conference in February 2025 signaled a paradigm shift, with the upcoming NATO summit in June as another key catalyst. The NATO members’ defense spending targets of 2% of GDP may be revised upward, potentially increasing European defense spending by EUR 230bn annually. Infrastructure and materials companies are set to benefit from investments in housing, transport, and energy, in our view.

Europe's gas and electricity prices remain high relative to the period prior to the Russian invasion of Ukraine. A ceasefire and political willingness could lead to lower energy costs, boosting European economic growth. In a 50% lower gas price scenario, we expect a 2% positive impact on European corporate earnings and a 50bps boost to European GDP. Beneficiaries in this outcome would likely include the industrials, chemicals, and automotive sectors.

So, while we see various lingering uncertainties for Europe, we stress the need to consider diversifying European equity exposure, especially for international investors whose allocations to the region are by choice rather than necessity. While we refrain from taking major country calls with the region, we identify select opportunities by style and theme that offer potentially appealing risk-return profiles and appear well poised to capitalize on further potential gains in European equities for the remainder of 2025.

Global asset class preferences

The asset class preferences provide high-level guidance to make investment decisions. The preferences reflect the collective judgement of the members of the House View meeting, primarily based on assessments of expected total returns on liquid, commonly known indexes, House View scenarios, and analyst convictions over the next 12 months.

Note that the tactical asset allocation (TAA) positioning of our different investment strategies may differ from these views due to factors including portfolio construction, concentration, and borrowing constraints.

Attractive: We consider this asset class to be attractive. Consider opportunities in this asset class.
Neutral: We do not expect outsized returns or losses. Hold longer-term exposure.
Unattractive: We consider this asset class to be unattractive. Consider alternative opportunities.

Note: For equities, we have collapsed "Most Attractive" with "Attractive" and "Least Attractive" with "Unattractive" from the five-tier rating system that is found in the Equity Compass into three tiers.

Appendix

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