European markets have been under pressure in recent years. However, the tide is turning for Europe and European equities given the current economic landscape, presenting an attractive opportunity for investors. Jeff Donlon, CFA, Managing Director of Manning & Napier's Global Strategies Group, answers a few questions to help investors better understand our outlook on Europe.

What factors contributed to Manning & Napier’s more favorable outlook on Europe?

We’ve seen a strong performance of European equity markets this year and in the past 12 months with three main contributing factors.

Healing in the banking system. The European banking system is now on more stable footing. Banks are better capitalized, demand for credit is growing again, and bank profitability is improving as provisioning and non-performing loan levels are in a downtrend.

Decreased political risk. Entering 2017, nationalist, protectionist, and anti-establishment forces across Europe seemed to be gaining in popularity. Fortunately, elections in France, the Netherlands, Austria, and elsewhere have resulted in these threats becoming less of a concern. The upcoming German election is also following a path that would preserve the status quo, and Brexit seems to be bringing the EU together rather than tearing it apart.

Pickup in global growth and trade. The world has been in a global synchronized expansion since the fall of 2016. For the first time since 2007, none of the 45 economies tracked by the OECD are seeing economic growth contract. Looking at global credit conditions, real rates remain low or negative, which is supportive of further growth and expansion in the months ahead.

What is your team monitoring in Europe?

There are a number of risks we are monitoring. The first is the sharp rise of the euro, specifically the pace at which it has been gaining strength since this past May. A stronger euro tightens financial conditions, acts as a headwind to inflation, and hurts the competitiveness of exports.

We’re also monitoring the potential for European Central Bank (ECB) policy error. Our expectation is that anything the ECB does to remove monetary accommodation will be very slow and gradual.
Equities globally have benefitted from central bank policies, and the potential for a gradual tapering of quantitative easing (QE) could cause disruption to credit conditions.

Geopolitics and risks related to euroskepticism have not gone entirely away. Next year’s Italian elections, the threat of Catalonia independence in Spain, the progression of Brexit negotiations, and tensions related to terrorism, immigration, income inequality, and high unemployment are some of the issues that still matter.

Lastly, we’re also monitoring for any significant slowdown in global growth and trade, and spillover effects from any unforeseen or hard to predict events, particularly the situation with North Korea.

What types of European companies offer attractive investment opportunities?

From a top-down view, we advocate building exposure to domestic-facing euro zone stocks whose businesses can benefit from improving consumption and business investment momentum. Retail sales growth in Europe is accelerating, industrial and manufacturing orders are exhibiting solid expansion, and employment growth in the euro zone has caught up with the U.S. after lagging every year since 2010. Domestic-focused stocks also benefit from a stronger euro as an appreciating currency supports domestic demand and income.

What countries in Europe do you like from an investment standpoint?

Currently, France is one of the countries that we view as having significant potential. The election of Emmanuel Macron and his party securing a Parliamentary majority provides an opportunity for France to pursue pro-growth labor and tax reforms. For example, we think Macron will pursue labor reforms that make it less difficult and costly for businesses to dismiss employees and additional reforms to decentralize bargaining. Meaning, companies will have more freedom to negotiate pay and working conditions, which can help to increase jobs and labor productivity. We believe these structural reforms would help France improve its potential growth rate and become a more attractive place to do business, very similar to what Germany did last decade.

We also like Spain because it’s one of the faster-growing economies in Europe. Spain is already benefitting from structural reforms implemented in 2012. In addition, Spain’s political backdrop is rather benign, and its banking sector is recovering and consolidating. Activity levels, employment, and earnings within Spain remain well below levels seen prior to the Global Financial Crisis, providing ample runway for growth to continue.

In summary, we believe Europe has reached an inflection point and investors should consider a meaningful allocation to European equities with a multi-year perspective. Europe has closed the growth gap relative to other developed markets, and Europe’s recovery from the Global Financial Crisis appears to be broadening out with more of the economic recovery being led by domestic demand.

To learn more about our outlook on Europe, listen to the replay of our webinar, Europe has Reached an Inflection Point, featuring Jeff Donlon. You can also download our new chartbook for more details on why we believe the European economy has reached an inflection point.