Equity Insight
April 2025

Monthly Equity Market Topics

The Case for Europe – Earnings and Multiple Convergence

Author

Ross Cartwright
Lead Strategist
Strategy and Insights Group

In Brief

- Earnings Convergence: European earnings growth is beginning to align more closely with that of the US.
- Fiscal and Economic Tailwinds: Europe benefits from fiscal headroom and strategic spending, which supports stronger economic and corporate profits.
- Technological and Geopolitical Shifts: Developments in AI and potential geopolitical resolutions, like in Ukraine, could further enhance Europe's prospects.
- Valuation Opportunities: European equities appear relatively undervalued, providing a buffer against market volatility and the potential for significant returns.

Shifting Global Equities Landscape

For the past fifteen years, US equities have dominated the global investment scene, overshadowing markets such as Europe and China. However, recent performance trends have seen Europe and China outperforming the US. This shift prompts the question: Are we experiencing a temporary reset, an inflection point, or a structural shift in the valuation dynamics between the United States and Europe?

The Drivers of US and European Market Returns

Historically, US outperformance can largely be attributed to superior earnings growth compared to Europe combined with significant multiple expansion. For instance, a quarter (3%) of the 12% annual return for the S&P 500 since March 2015 stemmed from an increase in P/E multiples from 18x to 24x.[1] In contrast, European multiples have remained relatively flat, with the MSCI Europe Total Return Index delivering a 6% annual return over the same period. Notably, even after recent market adjustments, US stocks continue to trade at a significant premium to European ones.

Multiple expansion explained half of the US outperformance, but the other half comes from earnings. The biggest driver of S&P 500 earnings over the past 10 years has been the Magnificent Seven. While the rest of the S&P 500 has delivered stronger earnings over this period, since COVID, European stocks have kept pace with the S&P 500 ex the Magnificent Seven stocks, despite weaker economic growth.

We see potential for European multiples to expand further while the upside for elevated US multiples may be limited.

Fiscal and Economic Tailwinds - Changing Growth Dynamics

The economic landscape is evolving, with Europe's GDP forecasts being revised upwards, while the US, which faces downward revisions due to reduced government spending, flagging economic confidence and tariffs.

Over the past five years, US Debt to GDP has risen by 17%, whereas it has decreased by 5% in Europe. The massive difference in fiscal spending has been a tailwind for US earnings relative to Europe. As Europe embarks on fiscal expansion, including Germany's defense and infrastructure package and the EU's ReARM Europe plan, these shifts indicate a potential for more robust income growth and corporate profitability in Europe. Fiscal contraction in the US is having a negative effect on income and profitability.

Yields on European bonds have risen on the back of the shifting fiscal landscape but the European Central Bank's rate cuts should start to have an impact following two years of tight financial conditions. European corporates and mortgages are largely exposed to falling shorter-term rates.

Impact of Technology and Geopolitical Changes

The Arrival of DeepSeek
The introduction of DeepSeek has transformed the AI landscape, reimagining the requirements for powering AI as adoption increases and models are commoditized. This shift could potentially deescalate the hype around AI investments, which has been a significant driver of recent US equity returns.

Ukrainian Peace Prospects
If achieved, a peace deal in Ukraine could positively impact European market sentiment and facilitate reconstruction efforts, thereby supporting economic recovery and corporate profit margins. At the same time, energy costs could fall if partial flows of Russian gas to Europe resume.

China
European companies are more exposed to Chinese consumers. While China's property market shows nascent signs of stabilizing, we may see increased consumer spending facilitated by government policies as Beijing focuses on improving domestic demand. We expect these measures to start bearing fruit later this year and into 2026.

Challenges and Uncertainties

Tariffs and Trade
The ongoing uncertainties surrounding tariffs pose significant risks and could prove to be headwinds against European growth. The fallout from these tariffs could have far-reaching implications for both European and US companies. We will hopefully know more after 2 April as we get a sense how countries respond to US actions. In short, we expect prices will go up and demand will be suppressed.

With all the uncertainly around the size, implementation and duration of tariffs, it's not a surprise that companies are not providing much insight into how tariffs may impact them. However, given strong earnings expectations, it looks like forecasts haven't been revised yet to reflect potential tariffs.

This is a time for individual company analysis to understand how their profitability could be impacted and their ability to adapt.

US Offshore Revenue and Global Demand

Approximately 40% of the S&P 500's profits come from outside the US. Since US companies have grown their share of global profits, they may find further growth more difficult in a less globalized, more adversarial environment. While tariffs have thus far been focused on goods, should retaliatory actions spread to services, this could be a meaningful negative for US corporate revenues.

Valuation Opportunities

Multiples are an expression of sentiment about future earnings. European equities remain relatively undervalued, and as sentiment and optimism across Europe improves, this should support multiples. We've laid out several reasons why ongoing concerns (and lack of clarity) about US growth, fiscal policies and consumer sentiment will, in our opinion, limit US multiple expansion.

Ongoing rebalancing of portfolios to reduce or remove a US overweight and capital flow adjustments may also be a medium-term benefit for European equities.

Given continued uncertainty, we anticipate ongoing volatility as markets react to the news and to the potential for escalating trade and geopolitical tensions. Should equity markets remain under pressure, focusing on valuation may provide an important margin of safety for investors, and here again, Europe is relatively better positioned than the US.

Conclusion

Given fiscal policy adjustments and shifting global dynamics, Europe may present investors with a compelling case, supported by a convergence in relative earnings growth and cheaper valuations. Given Europe's underrepresentation in global portfolios, a secular shift may be underway, with European equities offering a potentially valuable diversification opportunity.

Endnote

[1] Bloomberg, S&P 500 Total Return Index to 28 March 2025.

The views expressed herein are those of the MFS Strategy and Insights Group within the MFS distribution unit and may differ from those of MFS portfolio managers and research analysts. These views are subject to change at any time and should not be construed as the Advisor's investment advice, as securities recommendations, or as an indication of trading intent on behalf of MFS.

Diversification does not guarantee a profit or protect against a loss. Past performance is no guarantee of future results.