Goldman Sachs Research

Strategy Espresso: 7 US companies are bigger than the Eurostoxx 50

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Markets in Europe have gone up a long way – 15% returns since the start of the year is clearly a significant rise over such a short period. But does this mean they have gone up too much? In truth, while European equities have outperformed in $ terms so far this year (the euro has fallen around 7% against the dollar), much of this can be seen as a catch-up relative to the currency falls last year. **In dollar terms the stoxx 600 and the Euro Stoxx 50 remain at the same level as they were in September 2014. Indeed, more striking is that they are below the peak level they reached in 2007 even in Euro's (and 23% and 40% lower in $ terms respectively) and that's in nominal terms. The S&P is up around 35% over the same period.**

At any rate, what ultimately will determine how much further the market can rise is a combination of valuation and fundamentals, not how far the market has moved per se.

The main reasons why Europe has lagged the US in terms of performance relate to:

1) Politics and risk premia - the crisis in Europe has been longer and deeper and, at times, more existential. The equity risk premium is around 7% in Europe and 5% in the US according to our models.

2) Europe's economic recovery and profits have lagged behind.

So there is both a risk element to the poor European market as well as a fundamental one. But in the end the question for investors is how much of this is structural and permanent and how much is cyclical. If at least some of it is cyclical, then some of the metrics are starting to look stretched.

We know that dividend yields are high, particularly relative to risk free rates (10x those on German 10-year bunds), and that FCF yields are also high; there is plenty of cash - we estimate around €884 bn compared with around €1.5 tn in the US (as a share of total assets the difference closes somewhat at 10% in Europe and 12% in the US). But despite all of the well known problems, Europe has many excellent companies. In total the aggregate worth of these companies is still modest compared with the US.

Here are some light hearted comparisons (based on total market capitalisation data)

- **Apple alone is the same size as the whole Spanish equity market and bigger than Italy.**
- **The whole Italian stock market is worth about the same as Walmart and Microsoft combined- the S&Ps 3rd and 6th biggest companies**
- **The German equity market (Europe's biggest economy) is no bigger than the S&Ps 4 biggest companies**
- **The 40 biggest French companies (the CAC40) is no bigger than the US top 5**
- **Greece is no bigger than Salesforce.com, a company that has been public for a little over 10 years**
- **Starbucks is the same market capitalisation as the whole of Ireland**

The Map of Europe below shows some US companies in comparison to the size of the total market capitalisation of European countries. None of this should be taken to mean that US companies are necessarily expensive, but it does suggest that the potential for some of the European markets remains strong given:

1) The size of these European economies

2) The companies exposure to the rest of the World and

3) The low level of European earnings

While 7 US companies are the same size as the Eurostoxx 50 today, there were 11 US companies that matched the size of the Eurostoxx 50 in 2007.

A US equity map of Europe
US companies shown in each country equate to the size of total market capitalization in the country

Source: Datastream, Goldman Sachs Global Investment Research

Yes Europe has lots of problems, but Europe's 600 biggest companies (the Stoxx600) are less than half the size of the S&P 500.

It's also interesting that even in the context of Europe the Swiss market alone is bigger than Spain and the Netherlands combined. The UK 100 biggest companies (FTSE 100) are bigger than the CAC and Dax put together.

None of this tells us that the European markets need to go up, but it tells us something about the relative value attached to these countries' assets in public equity markets. It also shows us, however, that Europe has had a strong tendency to finance companies via banks and private equity as opposed to the public equity market in the past; something that might change with the changes to the banking system and the global exposure of businesses.

Of course the problem in Europe is that, unlike the US, profits have yet to recover. Many worry that, like the US, valuations have risen sharply and therefore there is little room for further expansion. It is certainly true that valuations have risen. Back in 2012, around the time of the Draghi 'do whatever it takes' speech, the market was trading at around 10x one-year forward earnings. It is now at around 16x - above the long-run average. But:

1) The market is trading at 16x mid cycle (compared with 17.4x peak earnings in the US).

2) It is difficult to compare to history given that German 10-year bund yields are just 30 bp (and 5-year yields are negative).

On the latter point please see 'Top of Mind: Negative Interest Rates: Helpful or Harmful? 27 February 2015'

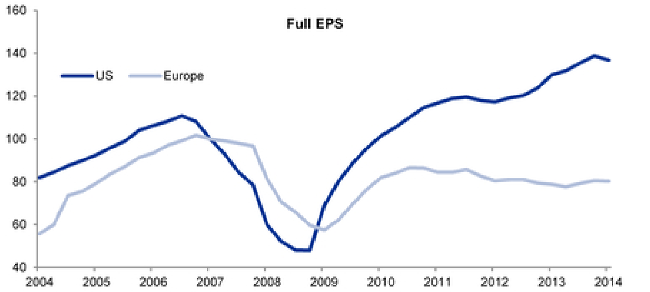
Up until recently these low rates have constrained the equity markets as they have been seen as a reflection of the stagnation in the European economy and the risk of deflation. **We have argued that if growth accelerates and deflation fears moderate, the very high equity risk premium can fall and allow the market to trade at a higher multiple**.

Ultimately the question about value in Europe therefore revolves largely around one issue; Is Europe's economy structurally impaired or is the weakness cyclical?

If you believe in the latter, despite the obvious demographic and political headwinds, then the market is likely to make further progress even if it appears expensive on a P/E basis.

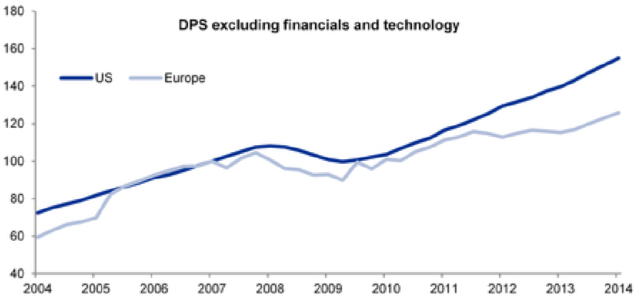
One important point to make; Earnings in Europe have been very weak and we expect only 4% growth this year for the Stoxx 600. However, excluding commodities we see earnings rising 11%. European profits and earnings are lagging the US, but less so if we exclude both technology (a boost to the US, but not so much in Europe) and Commodities. **But while profits and dividends still lag the US materially, some of this relates to the boost from technology that the US has enjoyed as well as the distortions from financials (which have, of course, been a drag on Europe). The charts below show that if we exclude both of these sectors Europe is less bad and the US less good. European profits are 8 % below their previous peak instead of 21% below. Dividends are 20% above their peak instead of flat**.

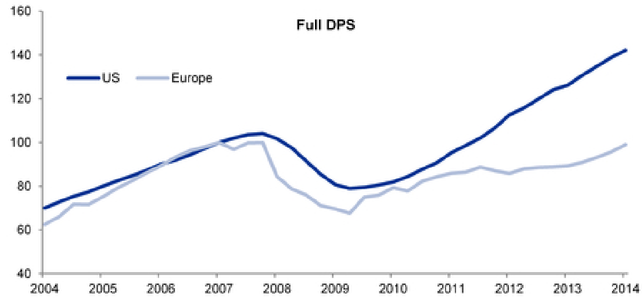
EPS comparison of US and Europe
Local currency. Indexed at 100 in Q4 2007



Source: Datastream, I/B/E/S, Goldman Sachs Global Investment Research

DPS comparison of US and Europe
Local currency. Indexed at 100 in Q4 2007





Source: Datastream, I/B/E/S, Goldman Sachs Global Investment Research

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