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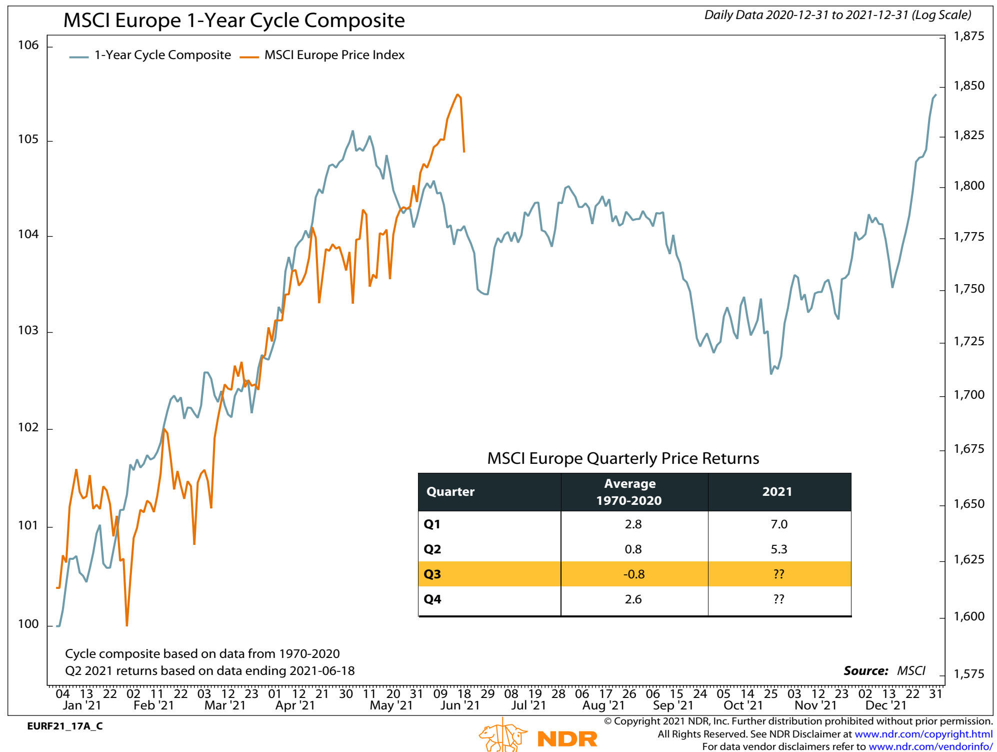
email us

European equity market cycles

Key Takeaways

- Analysis of the economic, earnings, and market cycles suggests a continuation of the current bull market.
- But economic sentiment is now excessive, suggesting much good news has been priced.
- Seasonality suggests a weaker third quarter.

Possibility of near-term weakness



Quarter	Average 1970-2020	2021
Q1	2.8	7.0
Q2	0.8	5.3
Q3	-0.8	??
Q4	2.6	??

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Staying constructive on European equities

While technical indicators continue to support the case for European equities, we ask the question: What do previous market, economic, and earnings cycles tell us about the outlook for the current bull market?

Our analysis of cycles supports the case for a continuation of the bull market over the second half of 2021. However, economic sentiment is now looking excessive suggesting risks have increased.

Third quarter historically weak

The third quarter has historically been weakest for the European equity market, falling by an average of -0.8%.

The MSCI Europe index has provided a total return of 66.1% since the March nadir last year and a return of 15.5% year to date.

A key tenet at NDR is "Don't fight the tape." Our European trend watch composite remains firmly bullish on equities. Further, the downward trend in high yield spreads is positive, and broad market participation remains supportive. Fifty-seven percent of stocks and 79% of European markets are above their 50-Day moving averages.

However, the announcement by the Fed last Wednesday, forecasting rate rises in 2023, earlier than previously forecast, rattled global equity markets. Therefore, as the market cycle matures, we need to be cognizant of the historical evidence to assess potential risk.

Certainly, **seasonality suggests that we could see weaker returns in the third quarter of 2021**, potentially followed by a quarter end rally.

The wisdom in the market adage "Sell in May," or more precisely sell on May 4 and buy on October 26, is illustrated in the chart above. The European equity market fell 2.4% on average during this period for data starting in 1970.

More broadly, the market has historically done best in the last and first quarter of the year, and worst in the third quarter where the average price decline has been -0.8%.

Maturing bull market

Comparisons with previous bull markets suggest that equities still have the potential to move higher over the next seven or eight months.

While equity returns have been excessive, the rise in equities since March should be viewed in the context of the drawdown that preceded.

In fact, there have been four other occasions since the mid-1970s when European equities experienced a drawdown of more than 30%. In all cases the nadir was followed by a substantial rally both in magnitude and duration.

The chart below illustrates, that while the exact trajectory varied for each case, the sharp rise in prices we have seen since March 2020 is not unprecedented.

In three out of four cases, European equities all rose to a peak between 22 and 23 months after the nadir, gaining between 66% and 88% in Euro price terms before seeing a decline in prices.

The current bull market is 15 months old, having gained 60%. If these three cases offer a guide, then **it is quite possible for European equity prices to rise another 10% in the next seven or eight months**.

Economy yet to peak

The OECD European composite leading indicator is still a significant way from that seen at previous market peaks suggesting equities could have more upside to come.

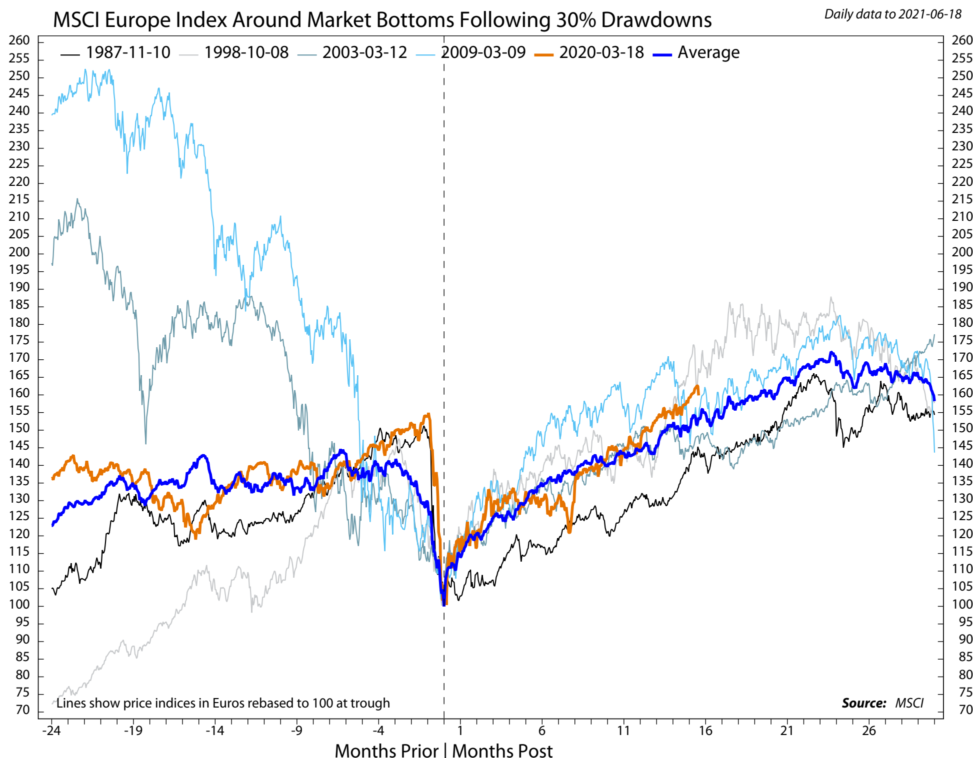
But all-time highs in industrial confidence suggest much good news is priced in and downside risks have increased.

Economic indicators also offer support for the continuation of the current bull market.

Over the past 25 years, peaks in European equity prices have tended to coincide with peaks in the OECD European composite leading indicator (CLI).

While we only know in hindsight when the peaks occur, and the indicator is subject to delays and revisions, the CLI can provide some gauge as to whether we are near a market peak or not.

Equities can still move higher



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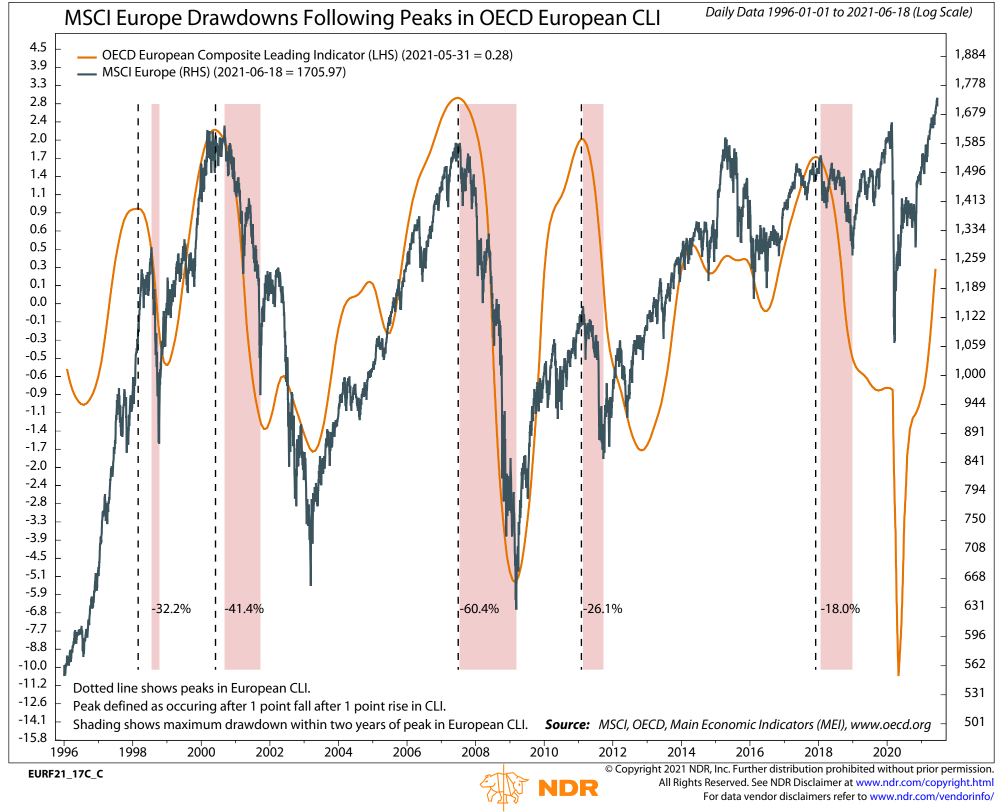
The chart right shows that there have been five peaks in the European CLI in the last 25 years, and that all five peaks were followed by significant equity market drawdowns.

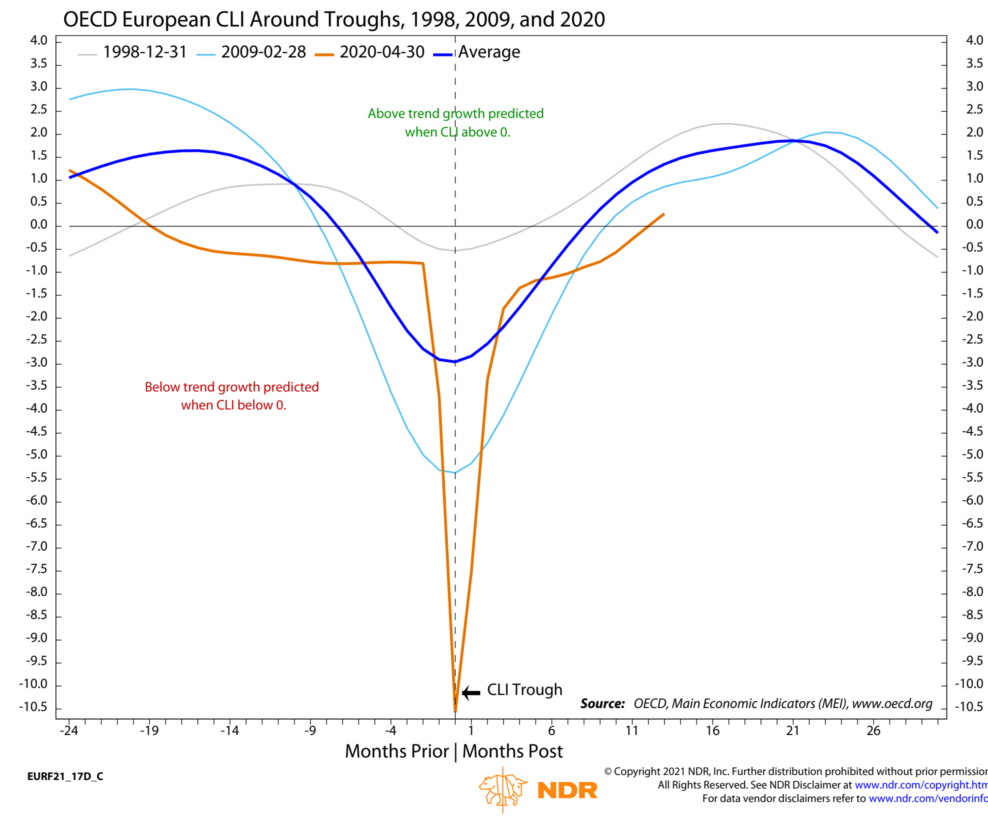
The chart also illustrates that market troughs tend to occur at around the same time as the troughs in the CLI. This was the case last year when the market bottomed on March 18, while the CLI bottomed at the end of April.

The chart below provides a comparison with two periods when the CLI reached a nadir around the same time that the equity market bottomed following a drawdown of greater than 30%.

Watch for peak in composite leading indicator



Expect further economic improvement



The chart shows that the CLI took between 17 and 23 months to reach a peak of between 2 and 2.2 With the current reading of 0.3 this suggests that leading indicators, and hence European equities, have still some way to go before reaching a peak.

What is also insightful is the time the leading indicator took from crossing the threshold between below to above trend growth to reach the peak. This was between 12 and 13 months in the two comparison cases.

With the European CLI only starting to indicate above trend growth in April, this suggests that **economic leading indicators will continue to improve over the rest of the year, supporting the bullish case for European equities**.

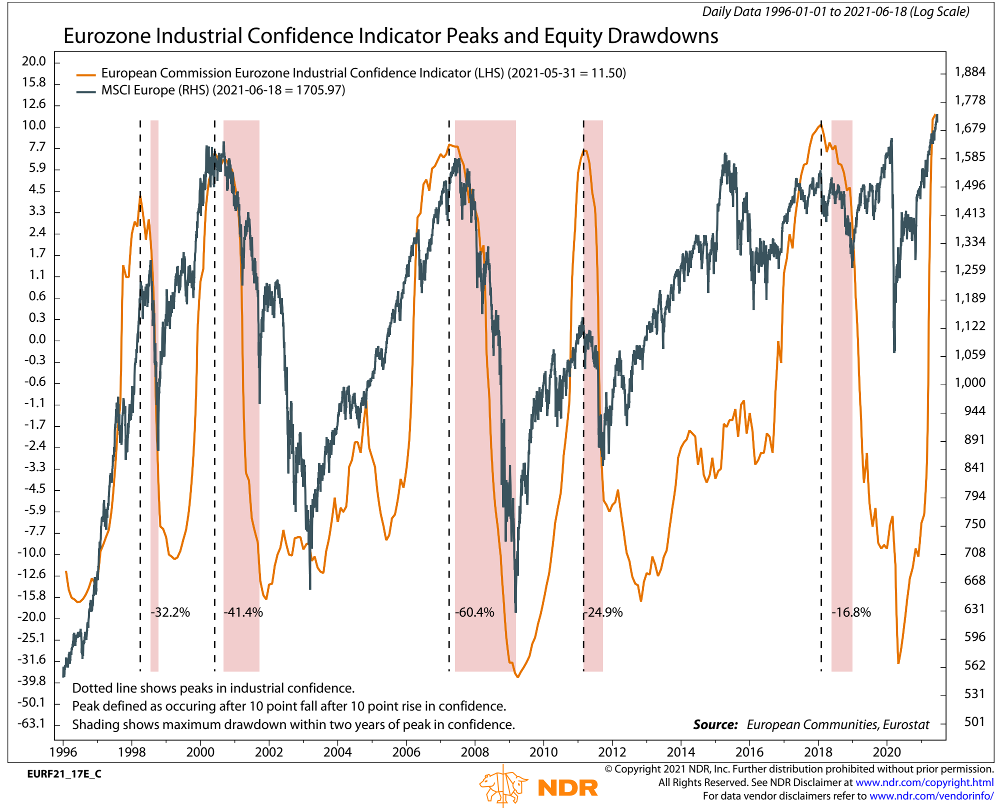
But signs of excessive optimism

While we do not see the European composite leading indicator peaking yet, **economic sentiment is starting to look excessively optimistic**. The latest reading for the European Commission Economic Sentiment Index of 114.5 is at levels like those we saw at previous market peaks.

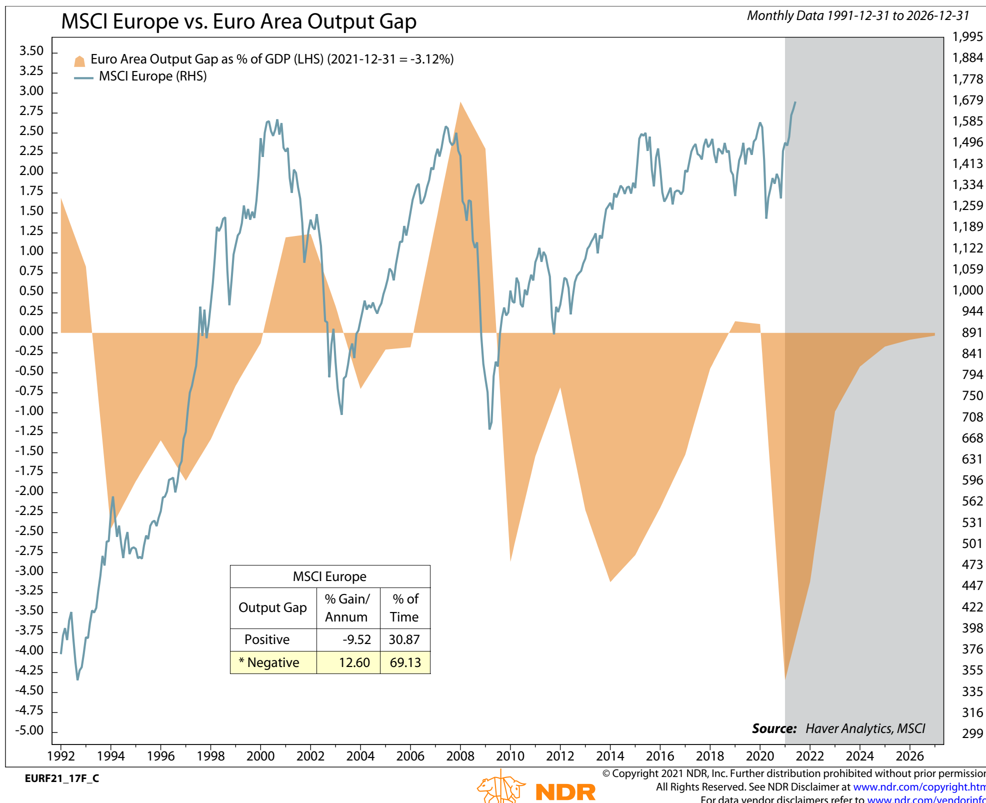
The sentiment index consists of five components, industrial, consumer, construction, retail, and services confidence, all of which are at elevated levels.

However, it is the industrial confidence component which stands out, with the most recent reading the highest on record. As a contrarian indicator, this suggests **much of the good news has been priced into European equities, signaling heightened downside risk**.

Drawdown danger?



Output gap negative for next five years



The chart above shows that in the past peaks in industrial confidence have tended to be followed by weak equity returns.

Plenty of slack in Europe

The eurozone output gap is projected to remain significantly negative this year and into 2022, providing plenty of scope for monetary and fiscal stimulus, a potential positive for European equities.

To offer further perspective on the economic cycle, it can be useful to look at the output gap.

As Ed Clissold notes with respect to U.S. equities, equities tend to perform best when the output gap (the difference between actual GDP and potential GDP) is extremely negative. This is something that is also borne out in Europe.

When the output gap is negative inflationary risks will be skewed to the downside. Hence, monetary policy will be more accommodative in turn stimulating economic growth and employment. Both increased liquidity and the prospect of an improving economy will boost equity prices.

In the chart at bottom of page 4 we see that European equities have tended perform better when the output gap is negative as is currently the case.

Further, actual GDP is forecast to remain below potential GDP five years from now, with the output gap forecast to be -3% in 2021, and -1% in 2022. This provides **plenty of room for monetary and fiscal stimulus, potentially offering support for European equities**.

Yields and yield curve

The recent rise in the yield curve is like that seen in the first quarter of 2017, which suggests prices could continue to move upward. However, if bond yields rise too much this could be negative for equities.

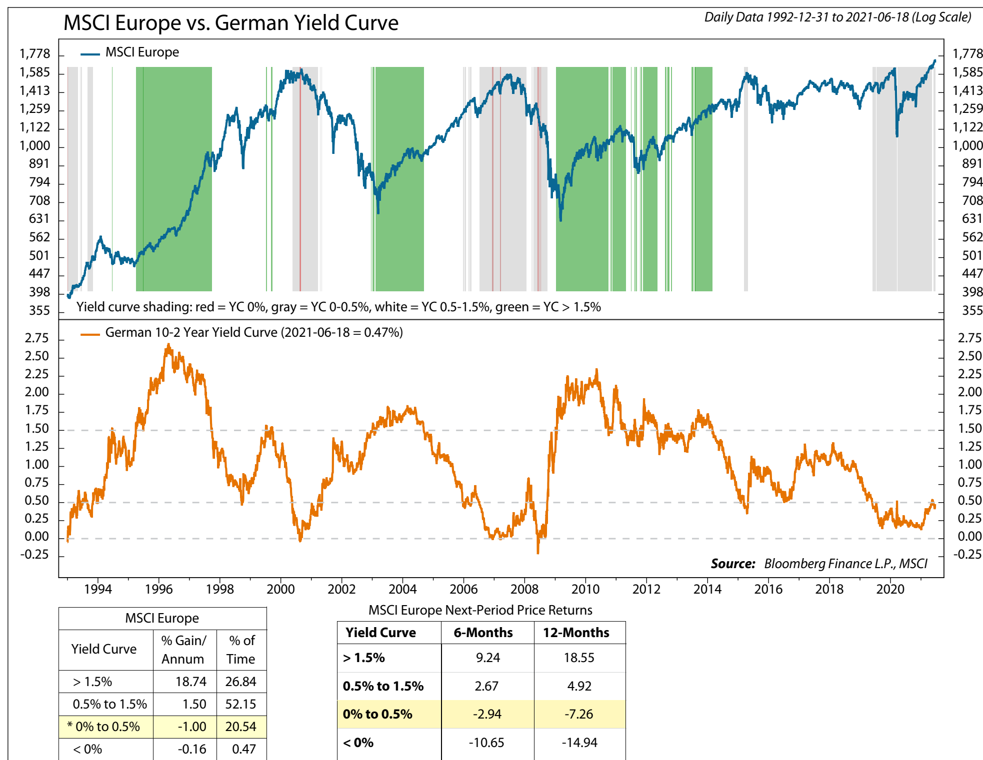
The output gap provides perspective, but the data has drawbacks in terms of frequency, data lags, and the use of forecasts.

Bond yields and the yield curve provide a real-time measure as to changes in the economic outlook. An inverted yield curve is regularly cited as a bearish economic indicator.

An inverted yield curve can result from a combination of rising short-term yields — reflecting near-term inflationary pressures, and a peak in the economic cycle — and falling long-term yields indicating long-term expectations for a deteriorating economy.

While an inverted yield curve has been rare, it proved prescient in 2000 and 2007 prior to the economic down-turns and bear markets that followed. The chart below illustrates the relationship between the yield curve and equity market performance.

Yield curve still flat



MSCI Europe		
Yield Curve	% Gain/ Annum	% of Time
> 1.5%	18.74	26.84
0.5% to 1.5%	1.50	52.15
* 0% to 0.5%	-1.00	20.54
< 0%	-0.16	0.47

MSCI Europe Next-Period Price Returns

Yield Curve	6-Months	12-Months
> 1.5%	9.24	18.55
0.5% to 1.5%	2.67	4.92
0% to 0.5%	-2.94	-7.26
< 0%	-10.65	-14.94

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For the period since end of 1992, a yield curve above 1.5% coincided with strong performance in equities and historically has been typical in the early stages of bull markets as indicated by the green shading. Conversely, flatter yield curves tend to coincide and be followed by lower returns.

The current yield curve at 0.47% then suggests limited upside. Certainly, long-term yields are consistent with low long-term economic growth forecasts.

However, what also needs to be borne in mind is the downward trend in long-term yields and the yield curve since the financial crisis. Notably, the strong recovery since March 2020 is comparable to those seen following the 2003 and 2009 nadirs, in spite of the persistence of a very flat yield curve.

Perhaps, what is of more relevance is the steepening of the yield curve. And in this respect the action in the yield curve is very similar to that which we saw in the six months ending March 2017, suggesting equities could move higher over the next six to nine months.

If the yield curve might have lost its predictive capacity in an era of structurally lower yields and quantitative easing, we should still be mindful of any significant changes in yields.

We highlighted earlier this month, that extreme rises in yields relative to a rolling three-year history have in the past preluded weak equity market performance, especially when valuations are stretched.

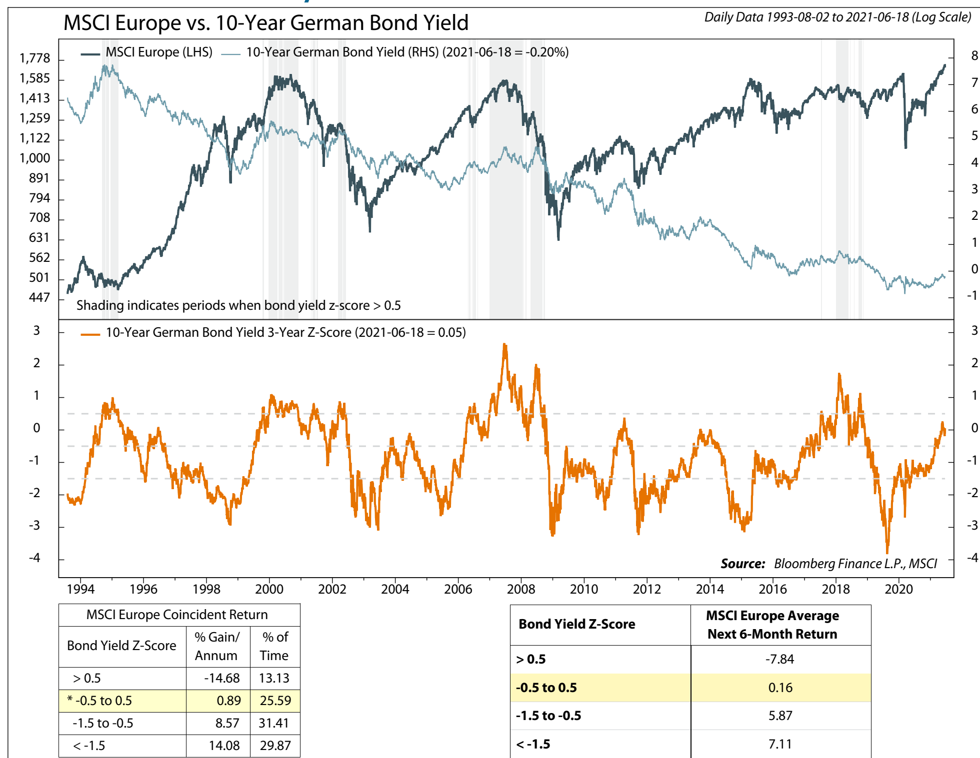
The chart below, highlights that **while normalized yields are not at historic extremes, this is something to watch**.

The earnings cycle

Accelerating earnings are currently positive for equities. However, forecasts show that earnings are expected to decelerate at the start of 2022, historically negative for equities.

The third cycle which can provide insight into the current bull market is the earnings cycle.

Yields not a threat yet



MSCI Europe Coincident Return		
Bond Yield Z-Score	% Gain/ Annum	% of Time
> 0.5	-14.68	13.13
* -0.5 to 0.5	0.89	25.59
-1.5 to -0.5	8.57	31.41
< -1.5	14.08	29.87

Bond Yield Z-Score	MSCI Europe Average Next 6-Month Return
> 0.5	-7.84
-0.5 to 0.5	0.16
-1.5 to -0.5	5.87
< -1.5	7.11

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We noted in March that European earnings troughed at the end of 2020 marking the start of a new earnings cycle. The start of the earnings cycle has historically been positive for European equities.

Three months on we have seen equities perform strongly and while the market appears to have priced in much good news, history suggests that **this stage in the earnings cycle remains on balance positive for equities**.

Over the long-term, earnings will drive equity prices and for tactical allocation, the earnings cycle is also important.

Long-term earnings growth forecasts determine equity valuations, which in turn tend to be biased by short-term growth forecasts. In the past when earnings growth has started to decline this has been negative for equities. Decelerating earnings have preceded significant drawdowns on several occasions in the past 15 years.

The second clip in the chart below illustrates periods of rising and falling earnings growth. **Earnings are currently accelerating** — that is earnings growth is increasing — which is **positive for equities**. However, earnings forecasts suggest that **earnings will begin to decelerate in early 2022, potentially negative for equities**.

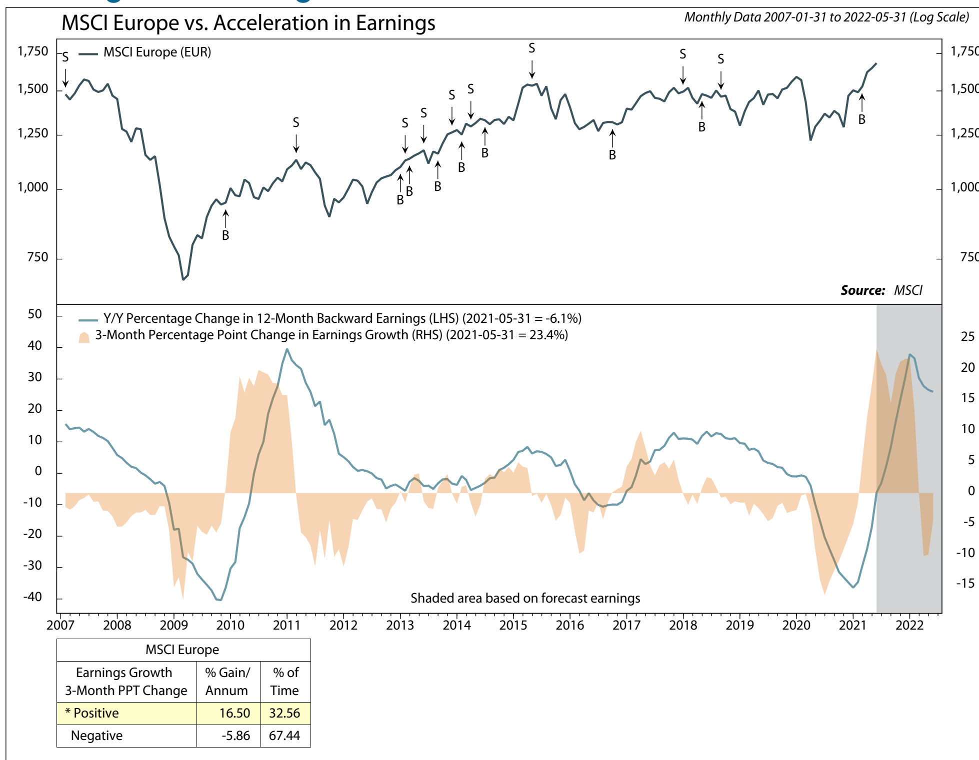
Remain constructive on European equities

Our analysis of market, economic, and earnings cycles suggests that the current bull market has further to run, corroborating the message from technical indicators. Although seasonality analysis suggests there could be a lull in equity markets in the third quarter.

However, we are seeing signs of excessive economic optimism and as we move into next year a potential deceleration in earnings could prove problematic.

For now, we remain constructive on European equities.

Earnings continuing to accelerate



MSCI Europe		
Earnings Growth 3-Month PPT Change	% Gain/ Annum	% of Time
* Positive	16.50	32.56
Negative	-5.86	67.44

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NDR HOUSE VIEWS (Updated June 3 , 2021)

NDR recommends maximum overweight allocation to equities, underweight allocation to bonds and marketweight allocation to cash. It is likely that we have seen a reset of the secular bull market that started in 2009.

Equity Allocation

U.S. | We are marketweight the U.S. relative to other regions but are bullish on an absolute basis. The rally from the March 23 low has met the NDR criteria for a cyclical bull market, and we are shifting to risk-on assets as models confirm. We favor small-caps over large-caps and Value over Growth.

INTERNATIONAL | We are overweight Europe ex. U.K., underweight U.K. and Pacific ex. Japan, and neutral on all other regions within our seven-way regional allocation framework.

Macro

ECONOMY | The global economy fell into its deepest recession in the postwar era due to COVID-19, but pent-up demand and robust stimulus is setting the stage for a strong rebound in growth in 2021. Inflation will jump in the short-term, but long-term trends are anchored.

FIXED INCOME | We are 85% of benchmark duration. We are positioned for a steeper yield curve. We are overweight MBS, ABS, HY corporates, EM, and TIPS. We are underweight Treasurys.

GOLD | Long-term uptrend intact. We are bullish.

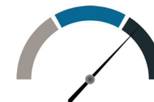
DOLLAR | Our long-term technical composite is negative. We are bearish.

Economic Summary

June 21, 2021

Near term activity: ● Accelerating ● Neutral ● Decelerating

Global Economy (6.1%)



U.S. Economy (6.5%-7.0%)

U.S. Inflation (2.5%-3.0%)

Economic gauges reflect changes in near-term economic activity. Numbers in parenthesis refer to NDR 2021 forecasts.

Global Asset Allocation

● Overweight ● Marketweight ● Underweight

- ● Stocks (70%)
- ● Cash (10%)
- ● Bonds (20%)

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

Equities — Regional Relative Allocation

- ● Europe ex. U.K. (17%)
- ● U.S. (57%) | Emerging Markets (13%) | Japan (6%) | Canada (3%)
- ● U.K. (2%) | Pacific ex. Japan (2%)

Benchmark – U.S. (57.9%), Europe ex. U.K. (13%), Emerging Markets (12.9%), Japan (6.7%), U.K. (3.7%), Pacific ex. Japan (3.1%), Canada (2.8%)

Global Bond Allocation

- ●
- ● U.S. (50%) | Europe (28%) | Japan (17%) | U.K. (5%)
- ●

Benchmark: U.S. (50%), Europe (28%), Japan (16%), U.K. (6%)

U.S. Allocation

- ● Stocks (70%) | Small-Cap | Value
- ● Mid-Cap | Cash (10%)
- ● Bonds (20%) | Large-Cap | Growth

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

Sectors

- ● Financials (13%) | Industrials (12%) | Energy (4%)
- ● Technology (24%) | Consumer Staples (5%)

Benchmark: Technology (27.0%), Health Care (13.5%), Financials (10.0%), Communication Services (11.1%), Consumer Discretionary (12.5%), Consumer Staples (7.3%), Industrials (8.3%), Energy (2.4%), Utilities (2.8%), Real Estate (2.5%), Materials (2.6%)

U.S. Bonds — 85% of Benchmark Duration

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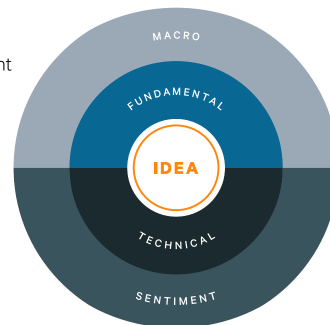

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