Strategy Matters

How far can equity valuations go?

Over the past 6 months, Europe equities rose 12% and all **of this rally has been driven by PE expansion, rather than earnings.** In fact, the 2024 consensus EPS estimate has been revised down 5% over this period. Trading on 13.5x 12m fwd PE, Europe equities currently stand half a PE point below their long-run average since 1990, and investors wonder how much upside is left.

Our freshly built PE model suggests that SXXP valuations can expand about 2.5% over 12 months. Combined with our EPS growth forecast of 4% per annum by 2026, this implies **a 6% price return over the next 12 months, 9% with dividends.**

Europe equities trade at a historical discount to US equities, even when we adjust their 12m fwd PE to medium-term expected profit growth (PEG ratio). If economic growth modestly accelerates and central banks embark on a rate cutting cycle in June, as our economists expect, valuations will rise further. Equities have probably reached the **Optimism phase, the last one of the equity cycle, in which multiples tend to rise while profit growth slows**. Rising oil prices present a two-sided risk to our forecasts: while they could delay the rate cutting cycle, they present upside risk to EPS growth.

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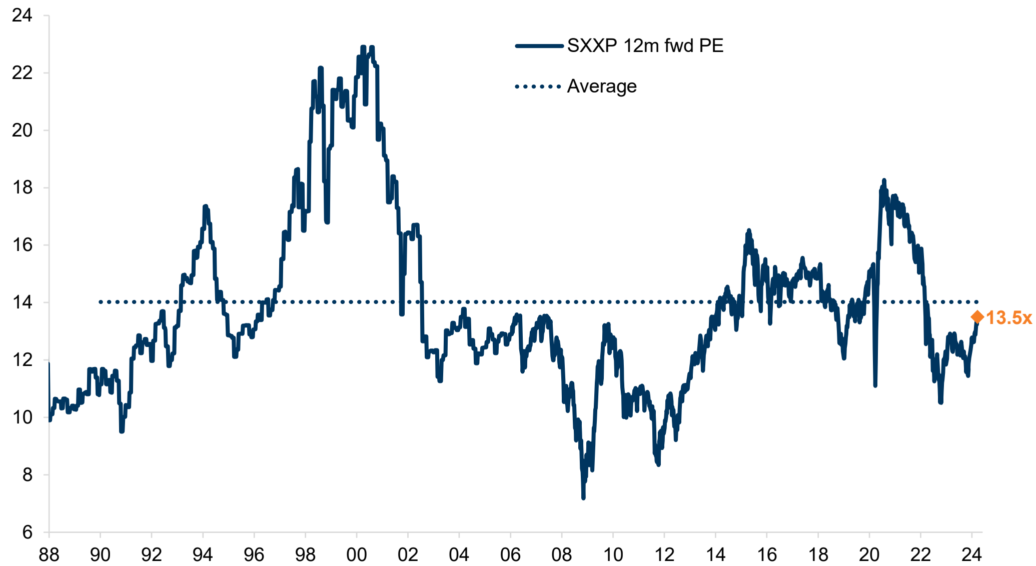
Exhibit 1: Europe 12m fwd PE stands half a PE point below its historical average



Source: IBES, Datastream, Goldman Sachs Global Investment Research

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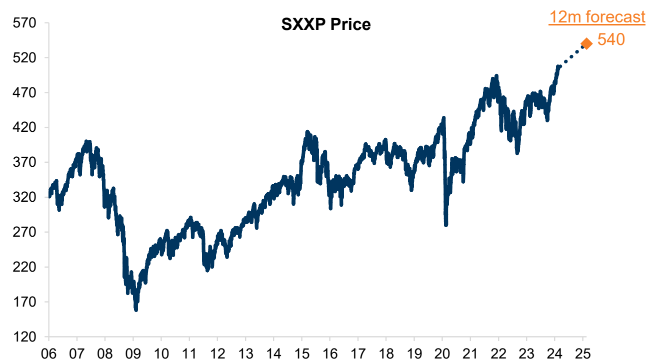
Our PE and EPS models suggest a 6% return over 12 months

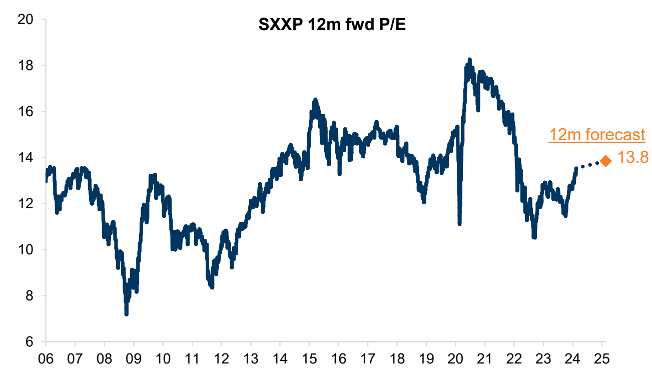
Our PE and EPS top-down macro models imply a price target of 540 for the SXXP in 12 months, i.e. a 6% price return, 9% with dividends.

Exhibit 2: Based on our EPS and PE top-down macro models, SXXP can get 6% higher in 12 months



Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 3: We expect SXXP 12m fwd PE to rise to 13.8x in 12 months



Source: IBES, Datastream, Goldman Sachs Global Investment Research

Exhibit 4: We expect SXXP to rise 6% in 12 months

	Current	In 12 months
12m fwd EPS	37.4	39.0
Growth in 12m fwd EPS		4.2%
12m fwd PE	13.5	**13.8**
12m fwd PE growth		2.6%
Price	510	**540**
12m price return		**6.0%**
12m total returns		**9.4%**

Source: IBES, Datastream, Goldman Sachs Global Investment Research

Exhibit 5: We raise our European target prices

European Indices Forecasts						
	STOXX 600		FTSE 100		SX5E	
Price level	New	Old	New	Old	New	Old
3 months	510	490	7800	7600	5100	4800
6 months	530	500	8000	7700	5250	4900
12 months	540	510	8200	7900	5400	5000
	STOXX 600		FTSE 100		SX5E	
Price Return (%)	New	Old	New	Old	New	Old
3 months	0.1	-3.9	-1.7	-4.2	1.4	-4.6
6 months	4.0	-1.9	0.9	-2.9	4.3	-2.6
12 months	6.0	0.1	3.4	-0.4	7.3	-0.6
Total Return 12m (%)	***9.4***		***7.5***		***10.6***	

Source: Datastream, Goldman Sachs Global Investment Research

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Our freshly built new top-down macro PE model predicts that SXXP 12m fwd PE will expand 2.2% in 12 months, from 13.5x to 13.8x, in line with the long-run average PE of European equities.

Our model relies on 4 explanatory macro variables, to predict changes in SXXP 12m fwd PE: economic growth, interest rates, distance to the 2% inflation target and a measure of economic policy risk. Our assumptions for each of these 4 variables as well as generic sensitivities of 12m fwd PE to them are specified in Exhibit 6 and Exhibit 7.

We discuss how we think each of these macro variables will impact European valuations in the next section and details on our model can be found in the Appendix.

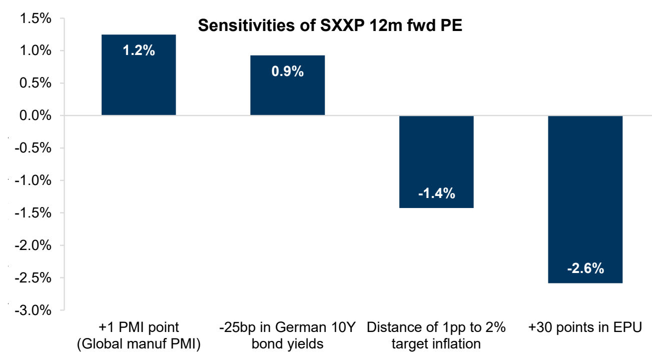
Exhibit 6: We expect SXXP 12m fwd PE to rise 2.2% to 13.8x in 12 months

	Portfolio strategy assumptions	% change on 12m fwd PE
Global manuf PMI (12m change)	+ 2pts	1.9%
German 10Y rates (12m change)	-25bps	0.9%
Distance of EA inflation from 2% target (12m avg)	0.38pp	-0.5%
Economic policy uncertainty (12m change)	Flat	0.0%
Change in 12m fwd PE		2.2%

Source: Goldman Sachs Global Investment Research

Exhibit 7: Sensitivities of SXXP 12m fwd PE to macro variables of our top-down PE model

Coefficients from our multivariate regression



Source: Goldman Sachs Global Investment Research

We continue to forecast SXXP EPS to grow 3% this year, 4% in 2025 and we initiate our 2026 forecast at 5%. In other words, we expect earnings to grow 4% per annum by 2026, which is conservative compared with FactSet consensus at 8%. However, bottom-up consensus tends to be revised down 5pp per annum.

For 2024, our sales-weighted GDP growth measure (an average of GDP growth forecast by our economists, weighted by SXXP geographical sales exposure) decelerates by 10bp compared with 2023, which should prevent net income margins from accelerating. As inflation slows and commodity prices do not increase much (2% based on the forecasts of our Commodities team), sales growth should be limited (although revenues are growing 2% on our forecast, an improvement compared with the 2% decline in 2023). We see upside risk to our forecast should commodity prices average $90/bbl in 2024 rather than $84/bbl. This would add 2pp to 2024 EPS growth.

See *Strategy Matters - Europe: Yearnings for earnings as growth slows*, 16 November 2018 for details on our top-down EPS model.

Exhibit 8: We expect SXXP EPS to grow 4% per annum by 2026

	GS Strategy			Factset consensus		
	2024E	2025E	2026E	2024E	2025E	2026E
SXXP EPS yoy growth	**3%**	**4%**	**5%**	**5%**	**11%**	**9%**
EPS level	36.1	37.7	39.5	36.7	40.6	44.1
SXXP ex Financials EPS yoy growth	**2%**	**2%**	**3%**	**3%**	**12%**	**9%**
Sales yoy growth	2%	2%	3%	1%	3%	4%
Net income margin (level, %)	8.1	8.1	8.1	9.1	9.9	10.3
Change in net income margin (%)	0%	0%	0%	2%	8%	4%
Change in net income margin (bp)	*0bp*	*0bp*	*0bp*	*20bp*	*75bp*	*41bp*
Financials EPS yoy growth	**5%**	**10%**	**8%**	**7%**	**8%**	**8%**
Commodity sectors EPS yoy growth	**1%**	**9%**	**9%**	**2%**	**7%**	**3%**
SXXP ex Commodities EPS yoy growth	**3%**	**4%**	**4%**	**5%**	**11%**	**9%**
SXXP ex Fin. ex Commods. EPS yoy growth	**2%**	**0%**	**2%**	**4%**	**13%**	**10%**

Source: IBES, FactSet, Goldman Sachs Global Investment Research

The macroeconomic cycle likely supports valuations

1. As economic growth picks up, valuations should rise

Europe equity valuations have not moved ahead of growth and should expand modestly further as economic activity rebounds. Valuations are highly correlated to economic growth and Exhibit 9 shows that changes in SXXP 12m fwd PE have closely tracked changes in PMI. Our global economists expect only a modest improvement in global manufacturing, which calls for limited valuation expansion. That said, recent early cycle indicators such as freight volumes point to a cyclical inflection (Exhibit 10), to which Europe is especially sensitive.

Our macro PE model (see details in Appendix) suggests that **for each 1 point increase in Global manufacturing PMI, SXXP 12m fwd PE rises 1.2%.** If by the end of the year the global manufacturing PMI rises to 52 (from 49 at the end of 2023), this would boost SXXP PE by 3.8%.

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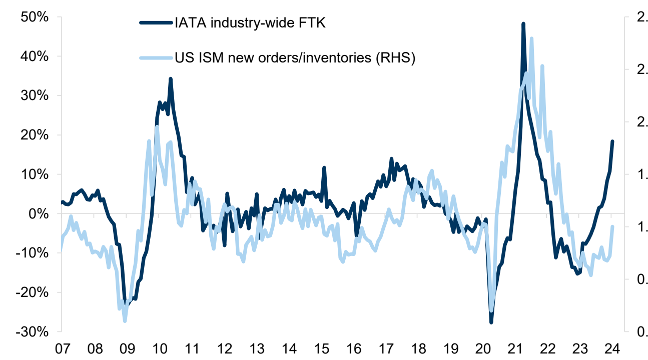
Exhibit 9: SXXP 12m fwd PE has not moved ahead of growth improvement

Source: Haver Analytics, Datastream, Goldman Sachs Global Investment Research

Exhibit 10: Global airfreight is now in one of its strongest yoy recoveries on record, off a low base

Global FTK growth yoy vs. US ISM new orders/inventory ratio (RHA)



Source: IATA, Datastream, Goldman Sachs Global Investment Research

Interestingly, we find that M&A activity tends to lag valuations rather than predict it. As equity valuations drop, the number of M&A deals tends to fall too in the next year. As Exhibit 11 shows, there is a strong correlation between changes in valuations and M&A deals with a one-year lag. **The recent rise in listed equity valuation suggests that the number of M&A deals should rise about high single digit this year**, after having fallen 27% in 2023 compared with 2022.

Exhibit 11: M&A activity tends to lag equity valuations by one year

Source: Bloomberg, IBE, Datastream, Goldman Sachs Global Investment Research

Valuations expand in the Optimism phase but are we there yet?

Various features of the market suggest that equities are in the Optimism phase of the cycle, which is characterised by valuation expansion. However, equities could also be in the Growth phase, where valuations fall. It is always difficult to identify the phase in which equities are in real time, and the Optimism phase is one of the most difficult to call.

Equities go through cycles, and behave differently depending on the phase in which they are. Our previous work shows that valuations expand the most in the Hope phase, when equities rally sharply after a bear market and investors pay in anticipation of future earnings (Exhibit 12). Equities then go through the

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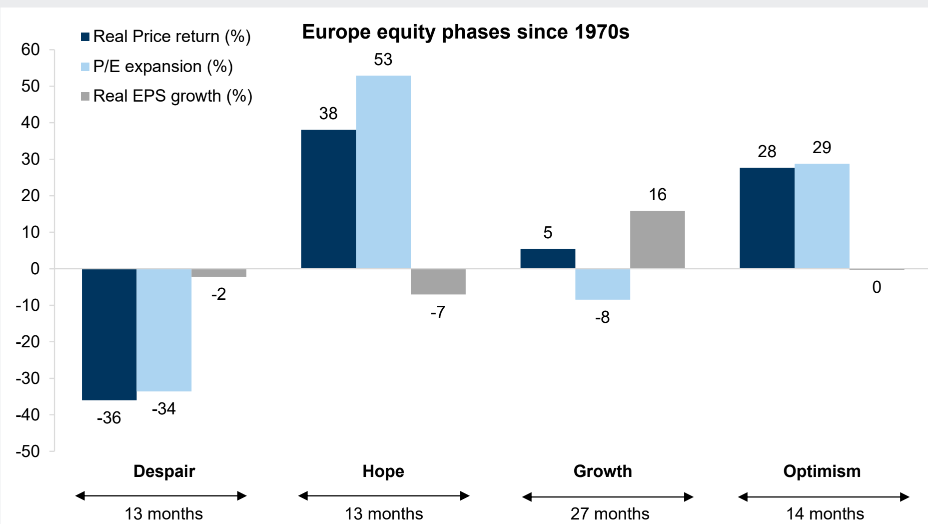
Growth phase, during which profits tend to drive (more modest) returns. At the end of this period starts the **Optimism phase, in which valuations rise anew, as investors continue to buy the market despite the fact that profit growth is slowing down.** This period lasts on average 14 months. See *The equity cycle part 1: Identifying the phases*, 22 October 2009.

Since the start of Covid-19, equities have entered what we dubbed the *Post-modern cycle* (Exhibit 13).

- **The Despair phase** started with the pandemic in February 2020 when the SXXP fell 35% in one month
- **The Hope phase** started in March 2020 when equities rebounded, driven by valuations while profits collapsed 29% that year
- **The Growth phase** started in 2021, when profits rebounded sharply, boosted by inflation and soaring commodity prices which fed into sales, as well as limited supply, supporting pricing and margin expansion. Profits rose 79% in 2021 and 21% in 2022. End of 2022 SXXP EPS was 54% above its 2019 level, making this the strongest EPS growth seen by Europe since 2003-2004.
- **Growth slowdown.** We estimate that profits fell 2% in 2023, and that they will grow 4% per annum by 2026. This slowdown in earnings growth could be the typical one you tend to see in the Optimism phase, when valuation expansion drives equity returns. But it could also be a prolongation of the Growth phase, morphing into a business cycle where the economic recovery is timid, inflation and commodity prices normalise and profits grow below trend.

Exhibit 12: Valuations expand the most in the Hope and Optimism phases of the equity cycle
Decomposition of SXXP returns since 1970s - Annualised growth rates



Source: Datastream, FactSet, Goldman Sachs Global Investment Research

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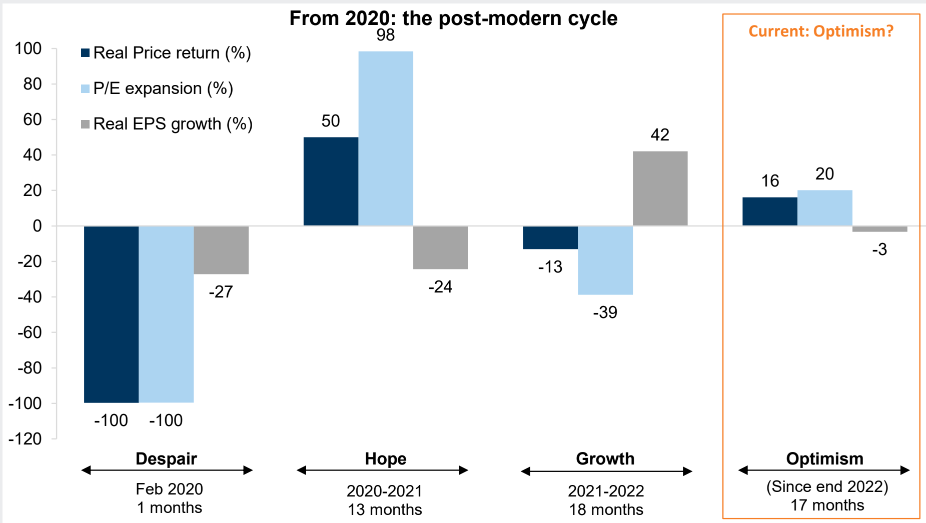
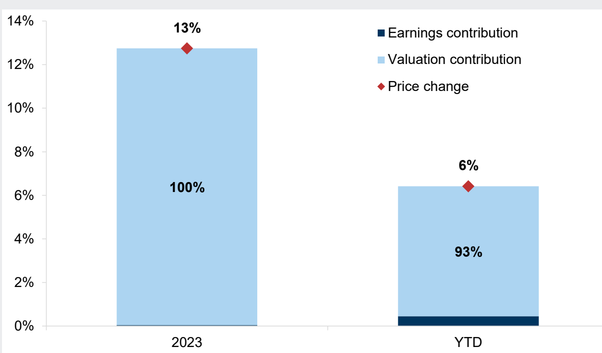
Exhibit 13: European equities could be in the last phase of the Post-modern cycle which started in 2020
Decomposition of SXXP returns in the current cycle - Annualised growth rates



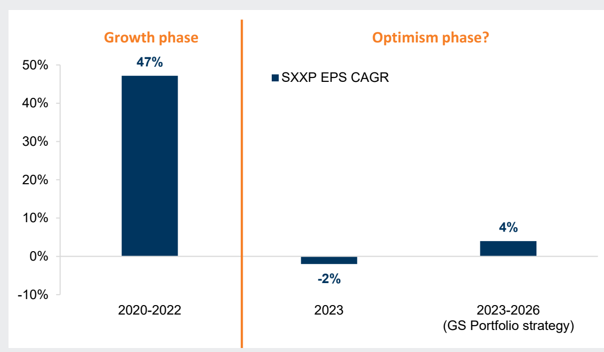
Source: Datastream, FactSet, Goldman Sachs Global Investment Research

Exhibit 14: Since the end of 2022, all the returns have been driven by valuations
SXXP return decomposition



Source: Datastream, FactSet, Goldman Sachs Global Investment Research

Exhibit 15: Earnings growth is set to slow compared with the Growth phase of 2021 and 2022



Source: IBES, Datastream, Goldman Sachs Global Investment Research

2. The rate cutting cycle should support valuations

As central banks embark on a rate cutting cycle, valuations tend to rise.

Based on the 6 Fed rate cutting cycles which took place since 1980, **S&P 500 12m fwd PE rose by an average of 9% 12m after the first cut, and 18% outside of recessionary instances. SXXP 12m fwd PE rose by an average of 19% in the 3 historical ECB rate cutting cycles** (See details in the grey box). At the moment, SXXP 12m fwd PE remains 15% below its beginning of 2022 level (15.8x), before central banks embarked on their rate hiking cycle. This is not the case for S&P 500 PE which is

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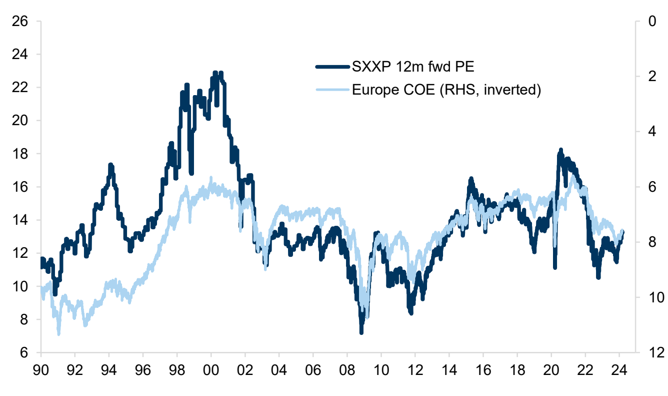
only 5% below.

If the fall in the risk-free rate (proxied by 10-year sovereign yields) is offset by a rise in the equity risk premium (ERP), then the cost of equity (risk-free rate + ERP) remains the same and there are no reasons for valuations to rise. This is why valuations fell in the years following the financial crisis. We believe that we are now in a more 'normal' environment, where deflationary risks have moderated. Falling bond yields should not be offset by rising ERP and should, therefore, be a positive for valuations. Exhibit 16 shows how closely linked 12m fwd PE and the COE are. From here, **a 100bp fall in SXXP COE would likely raise SXXP 12m fwd PE to 15x.**

History shows that **the COE falls by an average of 30bp 12m after the first cut, or 100bp when cuts are not followed by a recession (what our economists expect).** We estimate the cost of equity to be roughly 7.5% both in Europe and in the US, 150bp higher than where they were early 2022.

All other things equal, our top-down macro PE model suggests that **a 50bp fall in German 10-year bond yields boosts SXXP 12m fwd PE by 1.9%.** This sensitivity appears weak, because our model also captures the impact of growth and risk (see details in the Appendix). Often, moves in bond yields reflect moves in growth or changes in sentiment from investors, which are more important in driving valuation changes than the move in bond yields itself.

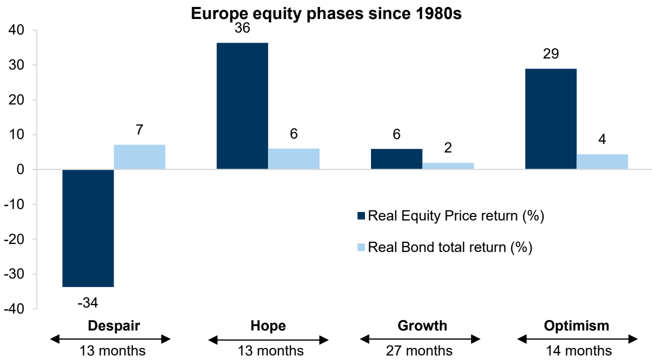
Exhibit 16: SXXP 12m fwd PE is tightly linked to the cost of equity
COE = risk free-rate (10y sovereign yields) + ERP estimated by GS



Source: Datastream, IBES, Goldman Sachs Global Investment Research

We also find that **equities tend to outperform bonds late cycle, in the Optimism phase (Exhibit 17), and when central banks are cutting rates.** Based on the past 6 Fed cutting cycles, the S&P 500 outperformed US bonds by a modest 3% 12 months after the first cut, but as much as 13% in instances where no recession occurred (Exhibit 18).

Exhibit 17: Equities outperform bonds the most in the Hope and Optimism phases of the equity cycle



Source: Datastream, FactSet, Goldman Sachs Global Investment Research

Exhibit 18: The S&P 500 outperformed bonds by 10% in the year following the first Fed cut, outside of recession instances

Dates				US stocks vs US bonds (total return)	
First cut	Last cut	Length of cutting cycle (years)	Recession?	12m after the first cut	At the end of the cutting cycle
Sep-84	Feb-88	3.4	No	-7%	6%
Jun-89	Sep-92	3.2	Yes	12%	13%
Jul-95	Nov-98	3.4	No	26%	74%
Jan-01	Jun-03	2.5	Yes	-9%	-34%
Sep-07	Dec-08	1.2	Yes	-24%	-49%
Aug-19	Mar-20	0.6	Yes	-5%	-31%
Average		**2.4**		**-1%**	**-3%**
Average recession		**1.9**		**-7%**	**-25%**
Average no recession		**3.4**		**10%**	**40%**

Source: Datastream, Goldman Sachs Global Investment Research

Normalisation cuts support valuation expansion

We looked at Fed cutting cycles since 1982 and observed the link with S&P 500 valuation based on 12m fwd PE. We did the same exercise in the Euro area but there have been only three cutting cycles since 2000, all in the context of a recession.

Exhibit 19: Normalisation cuts boosted S&P 500 12m fwd PE by an average of 18% 12m after the start of the cutting cycle

Dates				Fed funds rate		US 10 year sov. yields		Cost of equity		S&P 500 12m fwd PE	
First cut	Last cut	Length of cutting cycle (years)	Recession?	Level at the start of the cutting cycle	12m after the start	Level at the start of the cutting cycle	12m after the start	Level at the start of the cutting cycle	12m after the start	Level at the start of the cutting cycle	12m after the start
Sep-84	Feb-88	3.4	No	11.5%	-350bp	12.2%	-190bp			7.5	22%
Jun-89	Sep-92	3.2	Yes	9.8%	-156bp	8.4%	9bp			10.9	11%
Jul-95	Nov-98	3.4	No	6.0%	-75bp	6.2%	87bp	9%	-106bp	13.2	13%
Jan-01	Jun-03	2.5	Yes	6.5%	-475bp	4.9%	23bp	7%	-3bp	21.9	-1%
Sep-07	Dec-08	1.2	Yes	5.3%	-325bp	4.5%	-105bp	8%	14bp	14.3	-18%
Aug-19	Mar-20	0.6	Yes	2.4%	-225bp	2.0%	-147bp	6%	-42bp	17.4	28%
Average		**2.4**			**-268bp**		**-54bp**		**-34bp**		**9%**
Average recession		**1.9**			**-295bp**		**-55bp**		**-10bp**		**5%**
Average no recession		**3.4**			**-213bp**		**-51bp**		**-106bp**		**18%**

Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 20: ECB cutting cycles boosted SXXP 12m fwd PE by an average of 19% 12m after the first cut

Dates				ECB deposit rate			German 10 year sov. yields		Cost of equity		SXXP 12m fwd PE	
First cut	Last cut	Length of cutting cycle (years)	Recession?	Level at the start of the cutting cycle	At the end of the cutting cycle	Total change (bp)	Level at the start of the cutting cycle	12m after the start	Level at the start of the cutting cycle	12m after the start	Level at the start of the cutting cycle	12m after the start
May-01	Jun-03	2.1	Yes	3.8%	1.0%	-275bp	4.9%	27bp	6.3%	41bp	17.6	-5%
Oct-08	Apr-09	0.5	Yes	3.3%	0.3%	-300bp	3.8%	-57bp	9.3%	-136bp	8.8	48%
Nov-11	Mar-16	4.4	Yes	0.8%	-0.5%	-125bp	1.8%	-38bp	9.1%	-102bp	9.5	16%
Average		**2.3**				**-233bp**		**-23bp**		**-66bp**		**19%**

Source: Datastream, Goldman Sachs Global Investment Research

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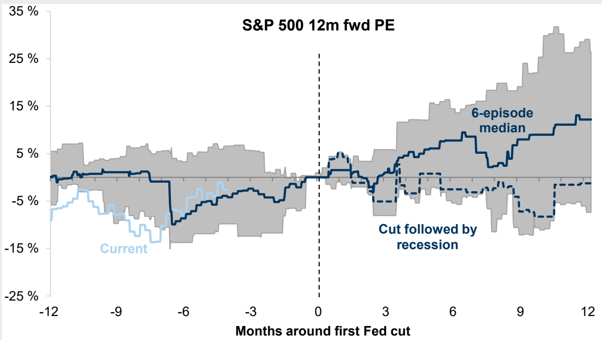
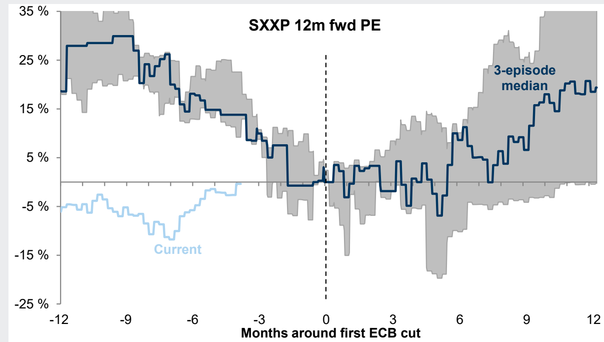
Exhibit 21: Normalisation cuts boosted S&P 500 12m fwd PE by an average of 18% 12m after the start of the cutting cycle



Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 22: ECB cutting cycles boosted SXXP 12m fwd PE by an average of 19% 12m after the first cut



Source: Datastream, Goldman Sachs Global Investment Research

Europe has room to catch up with the US

Over the past two years, the valuation gap between Europe and the US has considerably widened. From a 15% average discount, European equities now trade around their deepest discount (36%) in history. **European equities trade at about average, while US equities trade at around their 85th percentile,** whether we look at 12m fwd PE, PE adjusted of expected growth or cyclically adjusted PE (Price / 10y average EPS growth). Even excluding the Magnificent 7, the S&P 500 trades at 18.5x, around the top of its historical range.

The one valuation metric on which Europe has historically traded in line with the US is the PEG ratio (12m fwd PE / FY3 EPS growth, Exhibit 25). In other words, the PE premium paid by investors on US equities was explained by better long-term profit growth expectations. **However, this is not true anymore and the US PEG ratio has risen more than the European one.** Divergence in long-term economic growth expectations between the two regions does not justify this. As Exhibit 26 shows, US long-term economic growth expectations have always been higher but the gap has not widened of late. The decoupling in the US PEG ratio owes to that of Technology names in the stock market, which have seen their PEG rise more than the market (Exhibit 27).

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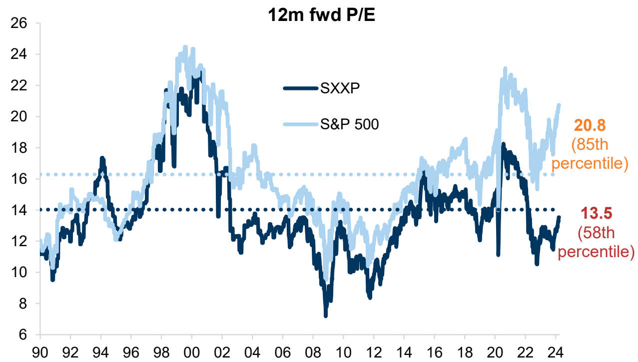
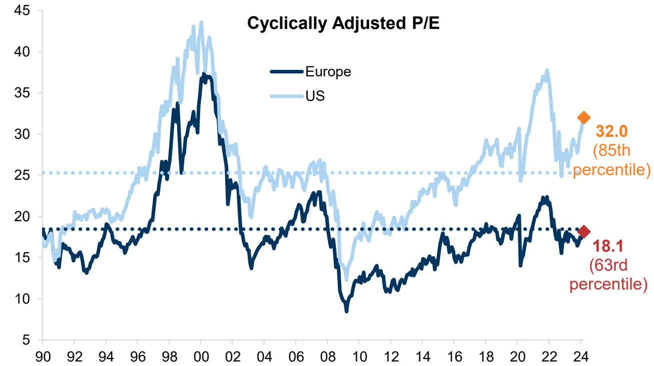
Exhibit 23: Based on 12m fwd PE, Europe equities trade just below average while US equities stand in their 85th percentile



Source: IBES, Datastream, Goldman Sachs Global Investment Research

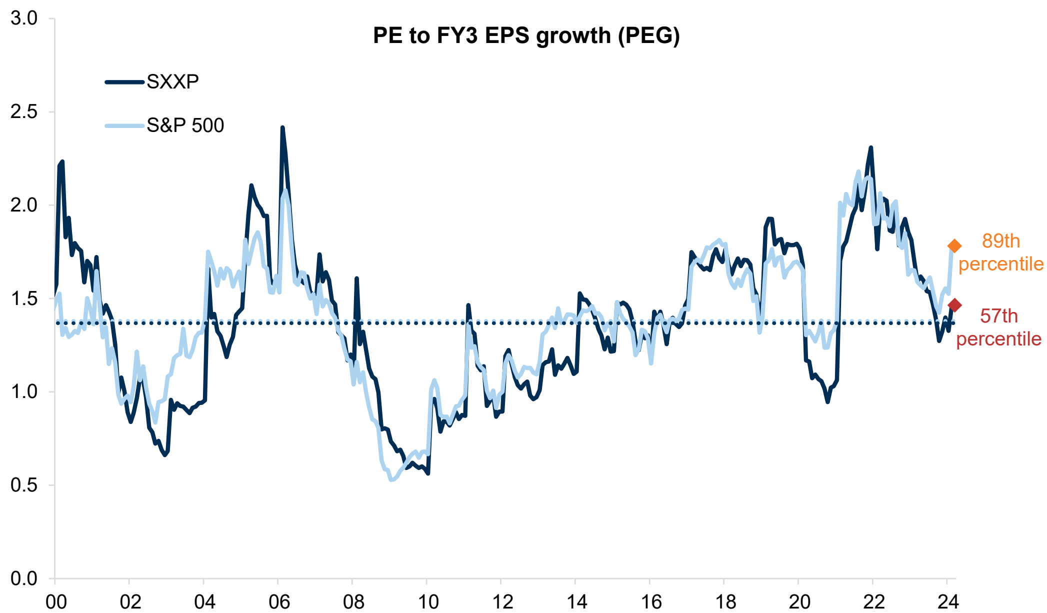
Exhibit 24: On a Shiller PE basis, Europe remains on lower valuation than the US

Real Price / 10y average real EPS



Source: IBES, Datastream, Goldman Sachs Global Investment Research

Exhibit 25: While Europe and the US used to trade on a similar PEG ratio, US PE has risen more than expected EPS growth



Source: IBES, Datastream, Goldman Sachs Global Investment Research

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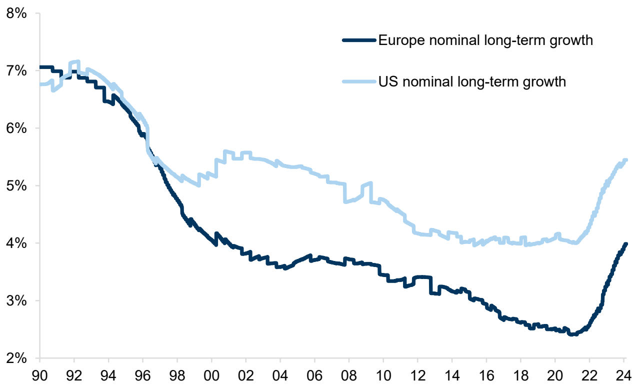
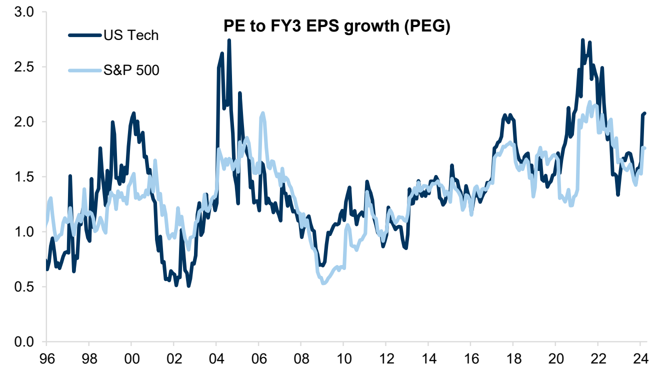
Exhibit 26: While Europe long-term growth expectations remain lower than in the US, they have increased in a similar fashion



Source: Consensus Economics, Goldman Sachs Global Investment Research

Exhibit 27: US Tech have pushed up the S&P 500 PEG ratio



Source: IBES, Datastream, Goldman Sachs Global Investment Research

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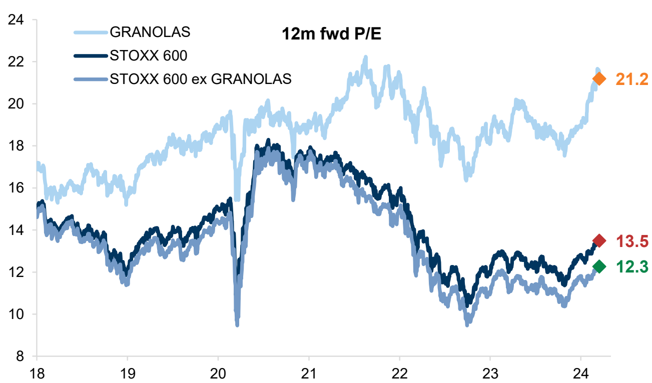
Breaking down the European market

How much cheaper does Europe look excluding the GRANOLAS? Not much. Excluding them, SXXP 12m fwd PE drops from 13.5x to 12.3x (Exhibit 28).

Finally, even excluding some of the cheapest sectors such as Financials and Resources, Europe trades on 15.9x, in line with its historical average excluding these sectors (Exhibit 29).

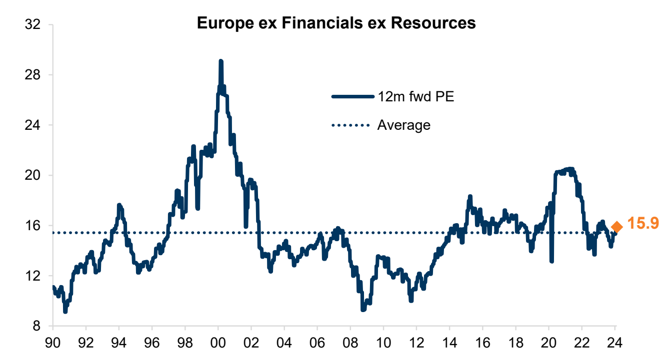
When making Europe sector composition similar to that of S&P 500, Europe's discount to the US reduces but is still the deepest historically.

Exhibit 28: Excluding the GRANOLAS, Europe is 1.2 PE points lower
12m fwd PE



Source: Datastream, IBES, Goldman Sachs Global Investment Research

Exhibit 29: Even excluding some of the cheapest sectors, Europe trades in line with its historical average



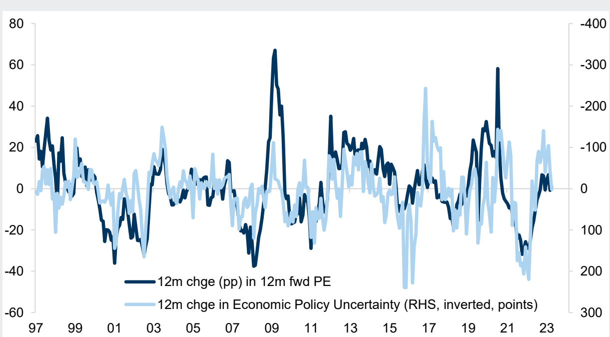
Source: Datastream, Worldscope, Goldman Sachs Global Investment Research

What could go wrong?

- **Rising geopolitical risk.** Europe equities are sensitive to international trade, geopolitics and economic policy uncertainty. As we discussed recently, the prospect of tariffs on exports to the US (a Trump proposal) and any reduction in funding for Ukraine (gaining support among Republicans) would both be significant negatives for European stocks (*Strategy Espresso: Trade, Trump, Geopolitics and Europe*, 24 January 2024). European valuations are especially sensitive to measures of risk, such as the equity risk premium, risk appetite, the gold price, or sovereign yield spreads. Our PE model uses the Economic Policy Uncertainty index (EPU) as a "risk measure" and Exhibit 34 shows that this variable is as important as economic growth in driving valuations. The EPU is a newspaper-based index counting relevant key words and our 2024 PE forecast assumes that the EPU stays flat (we do not forecast it). As an example, if EPU were to get back to levels last seen around the election of Trump in 2016 (+75 points), our PE model implies valuations could fall by 6%. Valuations are also very sensitive to the equity risk premium: we find that **a 50bp rise in the ERP lowers 12m fwd PE by 3.9%.** We did not include the ERP in our macro model because of circularity. The way we estimate the ERP is linked to market valuations given it is the rate which sets the current market price equal to fair value in our DDM.

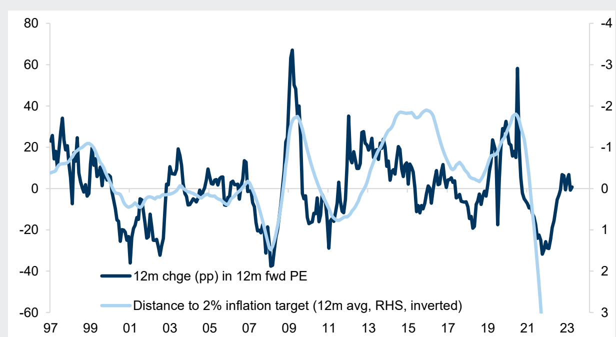
- **Reflation.** delaying rate cuts beyond the Summer would likely put upward pressure on long-term bond yields given current market pricing. This would put downward pressure on equity valuations. While not the base case of our economists (*Global Views: Cutting Through the Noise*, 18 March 2024), reasons could be reaccelerating commodity prices (the oil price is up 14% YTD), a tight labour market keeping wage growth elevated or supply shocks.
- **Lower equity demand.** our US colleagues showed that demographics, in other words the share of the population owning equities, does impact S&P 500 valuations. *US Equity Views - Fed cuts, real yields, and S&P 500 valuation*, 6 December 2023). In Europe, only 23% of the equity market is owned by Households, while more than 30% of the US equity market is owned by retail investors. This means that European multiples are less sensitive to demographics than their US peers.

Exhibit 30: SXXP valuations are sensitive to economic and geopolitical risks
The Economic Policy Uncertainty index is a newsbased index counting keywords related to risks



Source: Datastream, IBES, Goldman Sachs Global Investment Research

Exhibit 31: Higher inflation weighs on equity valuations



Source: Haver Analytics, Datastream, IBES, Goldman Sachs Global Investment Research

Appendix: Our GS top-down PE model

Our top-down macro model explains half the variation in the SXXP 12m fwd PE (adj. R2 0.494). Exhibit 33 shows the sensitivity of valuations to macro variables,

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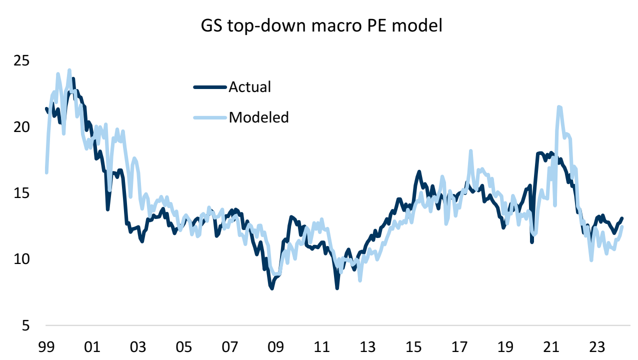
namely changes in Global manufacturing PMI, changes in German 10-year bond yields, changes in Economic policy uncertainty, and Euro area inflation (its distance to the 2% target). All variables are statistically significant at the 1% confidence level. We look at annual changes on a monthly basis since 1998.

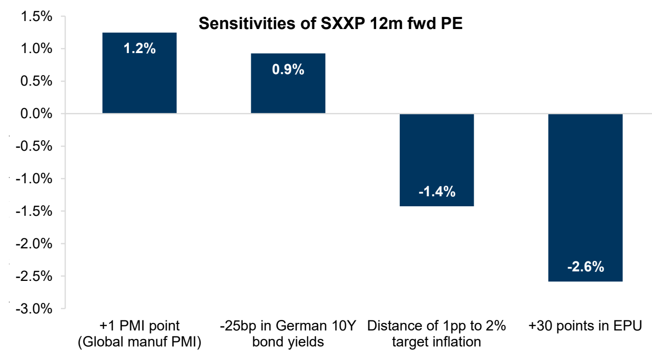
Exhibit 34 shows the importance of each explanatory variable (we normalised the betas): **growth and policy uncertainty are the most important variables.**

Exhibit 32: Our top-down 12m fwd PE model for the SXXP explains half of the variation in valuations



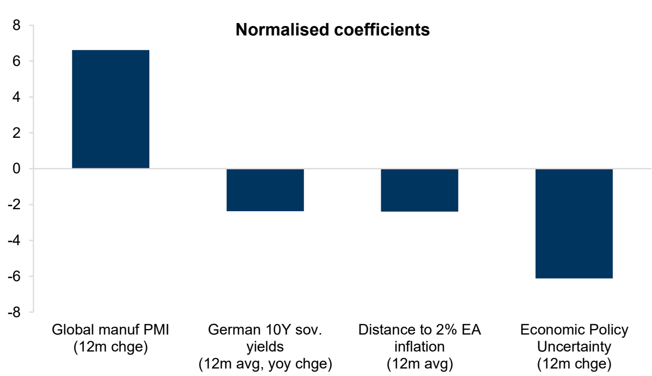
Source: Goldman Sachs Global Investment Research

Exhibit 33: Sensitivities of SXXP 12m fwd PE to macro variables
Coefficients from our multivariate regression-based model



Source: Goldman Sachs Global Investment Research

Exhibit 34: Economic growth and Uncertainty are the main drivers of changes in European valuations
Normalised coefficients of explanatory variables of the 12m changes in SXXP 12m fwd PE since 2000



Source: Goldman Sachs Global Investment Research

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Reg AC

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