The outlook for the eurozone has weakened somewhat in light of recent economic events, but we believe that pandemic-related headwinds could fade more quickly than the market expects. This edition of Global Insights examines the US, eurozone, inflation and currency hedges.

- Although not quite as strong as previous readings, eurozone PMIs still reflect a supportive backdrop.
- We find evidence that the worst could be behind us, as the Eurozone Citi Economic Surprise Index seems to suggest fewer negative surprises.
- The ECB remains among the more dovish central banks in the G10 and typically lags the Federal Reserve by six months.
- Reflecting the ECB's relative patience, we anticipate wider interest rate differentials between the US and Europe.
- US investors in European equities may be able to generate more attractive risk-adjusted returns by hedging their exposure to the euro, which may depreciate as result of interest rate differentials.
Our thoughts on growth. Although the outlook for the eurozone has dimmed in light of recent economic events, the region remains an attractive investment destination. On the surface, soaring European energy prices and global supply chain challenges remind investors that they will likely face headwinds over the next couple of months. Taking a step back, however, we see the risk/reward as more evenly balanced and believe that strong global demand, higher vaccination rates and supportive monetary policy will reward currently frustrated investors.

At the time of writing, eurozone industrial production, which measures output in mining and manufacturing levels, has dropped below pre-pandemic levels after retreating 1.6% in August. According to Morgan Stanley & Co.’s European economics team, activity in the eurozone likely peaked this summer, prompting the team to revise its third-quarter GDP forecast down to 2.0%. Still, we perceive ongoing growth momentum in the eurozone, given October’s strong purchasing managers’ index (PMI) readings for both services and manufacturing, at 54.7 and 58.5, respectively. While the economic data overall softened somewhat from the prior month, the near-record levels for these key surveys suggest that demand remains relatively strong despite immediate concerns.

While we are sensitive to Morgan Stanley & Co.’s more demure endorsement of the eurozone economy, we believe that upside surprises could be brewing. While it might be tempting to view headwinds as indicators of bigger structural problems, we don’t think that today’s concerns will derail the recovery, and we expect the economy to continue to grow from here, albeit at a somewhat slower pace.

In fact, we see evidence that a lot of the bad news has already been priced in. The Eurozone Citi Economic Surprise Index, which measures the degree to which economic data is either beating or missing analyst expectations, appears to have bottomed and is now starting to turn up. In fact, looking back over the last 10 years, we find that when the Eurozone Citi Economic Surprise Index has fallen at least one standard deviation below its average reading, the three-month forward returns for the MSCI EMU Index have been 5.5%, exceeding the average three-month return of 2.4% over the same period.

Our thoughts on inflation. UK natural gas future prices have eased following a dramatic move that sent the cost of contracts gaining as much as 400% since January, before retreating to 270% for the year to date. Although elevated energy prices will likely weigh on sentiment, we think that markets have overestimated the impact on consumers, given energy’s low contribution to consumer expenditures. That being said, higher prices have historically led to increases in headline inflation, presenting upside risk to the inflation outlook. In fact, according to the European Commission’s Eurostat agency, eurozone inflation climbed to its highest level in 13 years, underscoring the extent of the recent supply-side shocks. However, despite all of Europe’s inflationary pressures, wage inflation has remained stagnant. This is particularly noteworthy, given large wage gains in the US; as such, we believe that this dynamic should give the European Central Bank (ECB) cover to remain dovish longer (see Exhibit 1).

Morgan Stanley & Co.’s European economics team estimates that inflation will likely peak in the fourth quarter, as global supply-chain constraints ease and energy prices moderate. We see evidence that supply chain woes could be troughing and are encouraged by resilience in the automotive sector. For starters, the Manheim Used Vehicle Value Index, which we use here as a proxy for global conditions, has started to cool its growth. The index’s rolling six-month change likely peaked in May at 25.3% and, since then, has slowed every subsequent month, to September’s 14.3%. Additionally, the EURO STOXX Automobiles & Parts Index, which peaked in June, has retraced nearly half of its subsequent decline.

While it is hard to know for certain if we are finally turning a corner, investors are betting that the inflationary streak will moderate. The five-year/five-year forward inflation swap rate, a market-based inflation forecast, is comfortably below 2% and suggests that investors are not convinced that the ECB will fall behind the curve (see Exhibit 2).
Our thoughts on hedging. Given the attractiveness of the eurozone, US-based investors must decide whether to invest in the region’s equities and fixed income on a hedged or unhedged basis. Normally, when individual investors buy passive international strategies, they make an unhedged investment, taking a long, or bullish, position in both the underlying asset and the reference currency. In the case of European equities, for example, the investor would have exposure both to European companies and the euro. This setup introduces currency risk for US-based investors.

In order to mitigate the currency risk, investors can obtain exposure to international assets through currency-hedged vehicles, often exchange-traded funds (ETFs). In certain instances, hedging currency risk in European equities and fixed income has provided modest advantages for US-based investors through attractive cost-of-funding dynamics, termed “currency carry.” That is, over time, higher-yielding currencies have historically provided a slightly positive advantage. This outcome may emerge from positive growth differentials for higher-yielding currencies, which typically prompts capital inflows.

As seen in Exhibit 3, the US dollar faced similarly positive carry dynamics from 2014 to 2019. Over that timeframe, the EUR/USD exchange rate fell from 1.37 to 1.14, which would have weighed on unhedged exposures to European assets. To repeat the key message of this analysis, US investors who hedged currency exposure boosted their total returns.

As with other developed market currency pairs, the EUR/USD’s movements are intimately linked to the front end of interest rates, which are, in turn, influenced by relative central bank policy. By analyzing the relative policies of the Fed and the ECB, we can determine the likely short-term direction of these currencies and whether we expect the foreign exchange cost of carry to widen. Recently, the Fed’s tone has grown more hawkish, as it announced its intention to taper by year end and the possibility of a first rate hike by the end of 2022.

In contrast, the ECB has remained ultra-dovish. Historically, the ECB’s rate hike cycle has lagged Fed hiking by approximately six months, but we believe that the ECB may not budge as easily this time and anticipate that the front end of the US yield curve may rise higher than Germany’s, the de facto standard for eurozone’s risk-free rate. This potential situation bears similarities to 2018-2019 when the Fed hiked four times and the ECB kept its policy rate stable. During this period, the foreign exchange cost of carry rose as high as 4%, offering US investors a hedged net yield of nearly 7.9% versus 3.9% unhedged, while the hedged benchmark 10-year German government bond offered a 4.45% hedged net yield versus 0.45% unhedged. Given these dynamics, we recommend that investors consider currency hedging in Europe for both equities and fixed income over an intermediate horizon.

Please refer to important information, disclosures and qualifications at the end of this material.
Investment Implications

Although the outlook for the eurozone has dimmed in light of recent economic events, the region remains an attractive investment location. The Eurozone Citi Economic Surprise Index appears to be troughing and suggests that the bad news may already be priced into markets.

Energy troubles and supply chain woes are temporary. Higher vaccinations rates and supportive monetary policy should boost prospects for the region. The absence of wage pressures should provide the ECB flexibility to maintain a more dovish policy stances among the G10 central banks—which will be reflected in interest rate differentials. Should the ECB remain dovish while the Fed tightens monetary policy, we believe investors should consider currency hedging when investing in Europe for both equities and fixed income, given our observation that our forecasted setup has historically offered US-based investors an opportunity to benefit from currency hedging.
Charts You Can't Miss

Exhibit 4: MSCI Europe Index Yield Hedged vs. Unhedged

Exhibit 5: German 10-Year Government Bond Hedged vs. Unhedged

Exhibit 6: COVID-19 Cases in Europe Have Increased

Exhibit 7: Natural Gas Prices Have Started to Moderate as Supply Looks Set to Increase

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Oct. 18, 2021


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Current Readings From Our Quantitative Framework

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Ongoing Development Spotlight

Europe has the lowest domestic exposure among the major regions and derives over half of corporate revenues from outside of Europe. Unlike the US, where domestic consumption is a larger driver of profits, Europe’s outlook is more closely tied to international markets. After peaking in August, the MSCI Europe Index has traded lower. This has been driven in part, by China’s perceived slower growth path, following a weak third-quarter GDP print, headwinds from disruptions in global supply chains and seasonal challenges related to energy. We are not convinced that the global recovery is over and see periods of weakness as opportunities to add to Europe, whose companies are most levered to global economic growth.

Exhibit 8: European Companies Derive More Than Half Their Revenue From Outside Europe

Note: For Europe, Domestic refers to exposure to Developed Europe. For other regions, Domestic refers to the company's country of domicile. Data refers to MS & Co. analyst 2021 estimates, based on company information combined with projections when disclosure is not sufficiently detailed. Source: Morgan Stanley & Co. Research, Morgan Stanley Wealth Management Global Investment Office as of June 13, 2021.
Disclosure Section

Risk Considerations

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies. Technology stocks may be especially volatile.

International investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies. Investing in foreign emerging markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks.

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