C WORLDWIDE
ASSET MANAGEMENT

Q2 2025 | Senior Analyst Marcus Bellander

Why the US outpaced Europe – and why it might not last

US and European stock markets have moved in tandem from 1996 to 2015, where the S&P 500 returned 8.2% per year, while the STOXX Europe 600 returned 8.0%. However, in 2016, their paths diverged, and until 2024, the S&P 500 returned 12.4% per year while the STOXX Europe 600 returned a more modest 7.3%.

This divergence has led many to conclude that the US is the promised land while Europe is a wasteland. While there are many reasons to be impressed by the US, investors should not disregard the Old Continent, Europe.

Key insights

- The outperformance of the US stock market vis-à-vis the European market can be explained by the rise of US tech companies rather than a considerable difference in economic growth.

- US tech companies' growth is slowing, and US GDP growth may slow too, as its budget deficit must shrink.

- We have seen a concentration of US stock market returns, a concentration of US incomes, a concentration of US political power, and a strong US dollar. It may be time for investors to rethink regional allocations.

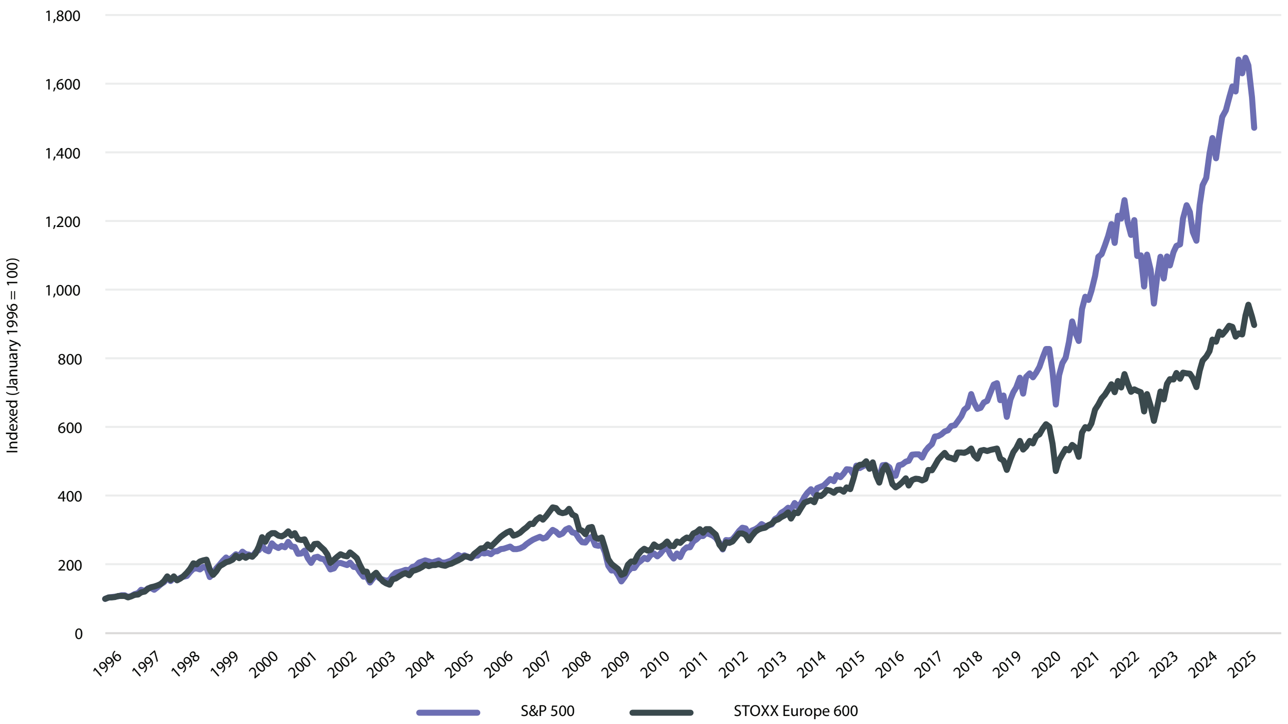
US and European GDP growth – not so different after all

While the divergence in stock market performance between the US and Europe (See figure 1) has been eyewatering, the difference in broader economic performance has not. In terms of GDP growth, the US has outpaced Europe, but only by a relatively modest 0.8 percentage points annually in the last ten years (and in the last thirty years – figure 2, page 3). Almost half of those 0.8%-points may be attributed to the increasing US budget deficit; from 2014 to 2024, the US budget deficit increased from 2.8% to 6.3% of GDP, or 0.35% per year. Meanwhile, European budget deficits were broadly unchanged, around 3.0%.

With a debt-to-GDP ratio of 123%, the US will eventually need to reduce spending. The tailwind created by an increasing deficit in the last ten years will then turn into a headwind. On the other hand, Europe seems keener than ever on spending; even

Figure 1

Divergence of equity market returns between the US and Europe



Source: Bloomberg, 29 April 2025

the frugal Germans are taking the foot off their so-called debt brake. With a debt-to-GDP ratio of 88%, there is at least some room for increased outlays.

Thus, the gap in GDP growth between the two continents may narrow considerably in the coming years, perhaps even widen in favour of Europe.

> **While there are many reasons to be impressed by the US, investors should not disregard Europe.**

Tech stocks are the missing link

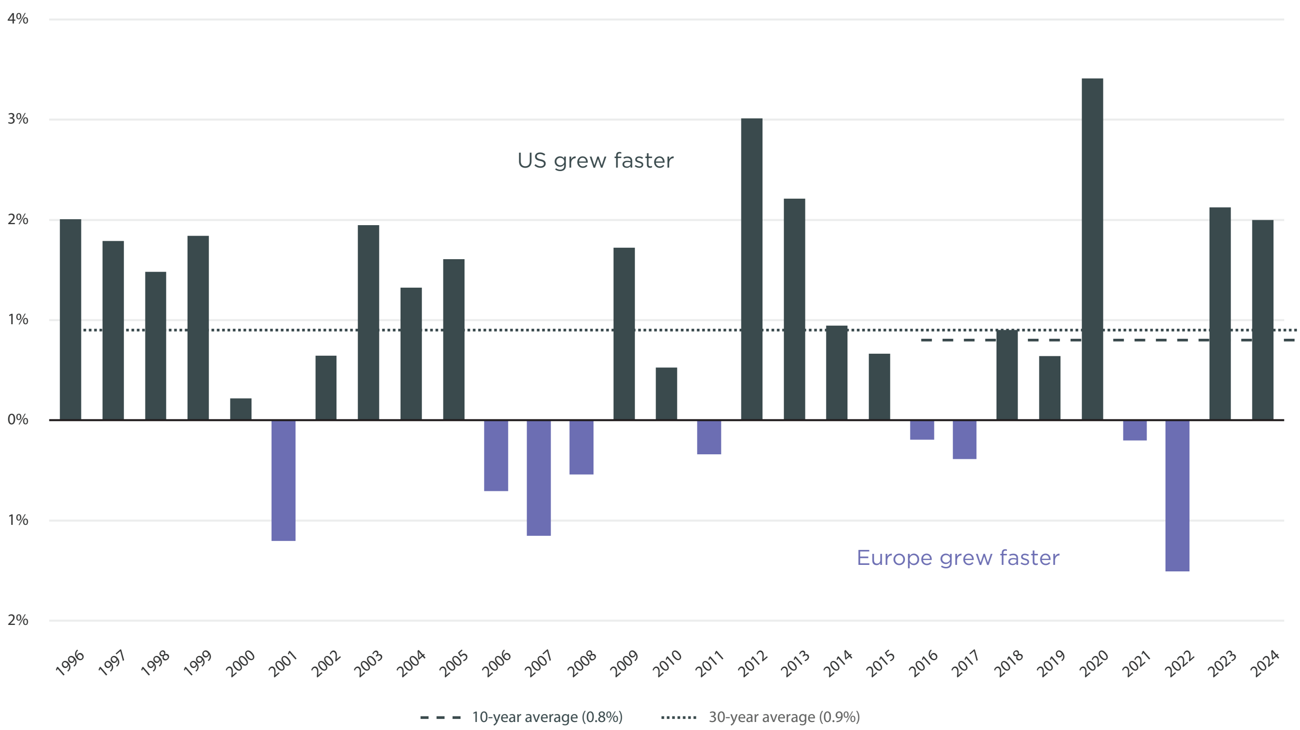
From 2015 to 2024, the average annual earnings growth of the S&P 500 was 9.7%. Excluding the information technology sector, that number drops to 5.9%. That is a mere 1.2 percentage points more than the 4.7% average earnings growth of the STOXX Europe 600.

If we also adjust for the slightly (0.4%-points) higher average inflation rate in the US, the difference in earnings matches the 0.8%-point gap in GDP growth. In other words, US exceptionalism rests heavily on the country's publicly listed tech firms. US tech firms still seem to have a bright future. They are in pole position to capitalise on the AI wave, which has just started washing over the economy. Most of them are global by nature and thus not bound by the growth of the domestic economy. The total revenue of the so-called Magnificent 7 "only" corresponded to 1.9% of global GDP in 2024 (up from 0.6% in 2014).

Yet there are signs of deceleration. The aggregate revenue of the Magnificent Seven (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia,

Figure 2

Difference in GDP growth between the US and Europe



Source: OECD, 29 April 2025

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If the AI momentum moderates, earnings downgrades may be significant.

Tesla) grew by 16% annually from 2015 to 2024. Revenue growth is expected to be 10% per year from 2025 to 2027.

Much of that growth depends on one factor: artificial intelligence. The Magnificent Seven were arguably more diversified when Alphabet was an advertising company, Amazon was an online marketplace, Microsoft focused on operating systems, and Nvidia made graphics cards. If the AI momentum moderates, earnings downgrades may be significant.

Additionally, it seems regulators' scrutiny of Big Tech has increased. Multiple antitrust cases are now active, while very few existed a decade ago. And deals done ten years ago, such as Facebook's acquisition of WhatsApp and Instagram, would likely face far more resistance today.

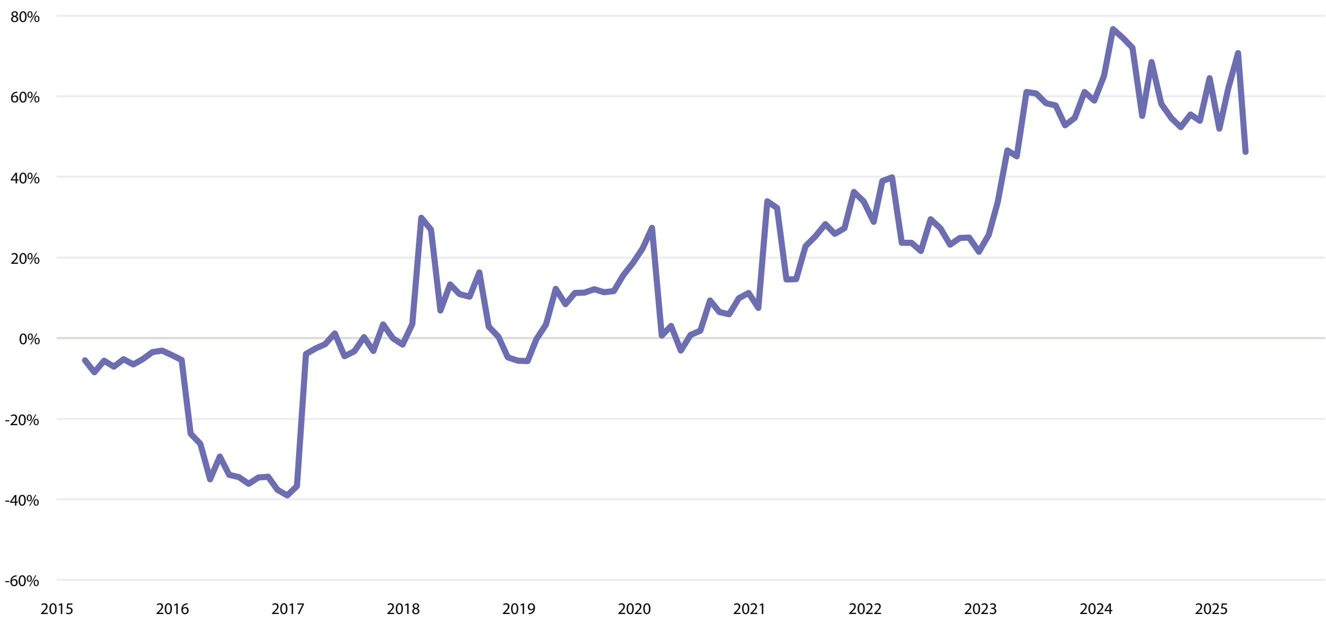
Perils to the left of me, dangers to the right

The valuation of tech firms reflects neither slowing growth nor increased risk concentration. At 46%, their valuation premium to other stocks is high (albeit down from recent peaks – figure 3). They now constitute 26% of the S&P.

Risk concentration in the US also occurs outside the stock market. According to Moody's Analytics, the top 10% of income earners in the US account for 50% of all spending, up from 36% three decades ago. Their spending power is partly linked to the stock market (they earn three-quarters of all US

Figure 3

The IT sector's premium vs. rest of S&P 500 (P/E)



Source: Bloomberg, 29 April 2025

capital income), meaning a downward spiral may be more pronounced than in the past if one were to start.

Furthermore, given the current administration's "break-eggs-to-make-omelette" politics, the range of possible outcomes for the US economy is wide. Black swans, such as a deep recession and/or a credit event related to US government debt, seem less improbable than a few months ago.

Lastly, the US dollar may weaken if the US economy and stock market falter. Indeed, the dollar is already starting to show some signs of weakness. It is at the high end (78th percentile) of the historical range against a basket of major currencies. In short, if the dominoes start falling, those heavily exposed to the US stock market may be hit hard.

The case for Europe

In Europe, fast-growing, large-cap tech stocks are rare. However, it offers other interesting investment opportunities. Many engineering and medical companies in northern Europe are global leaders in their areas, the French and Italian luxury goods companies are in a class by themselves, and more than a few of the continent's domestic energy companies have grown into world-class renewable companies.

European politicians' efforts to boost growth are not limited to increased government spending. Based on Mario Draghi's September 2024 report on European competitiveness, the European Commission is trying to close Europe's productivity gap versus the US. While the jury is still out, that is another factor that could help close the gap in GDP growth between the two blocs.

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For active managers running concentrated portfolios, Europe offers plenty of high-quality companies to choose from.

Furthermore, the stock market's valuation is considerably lower in Europe than in the US. At a forward 12-month P/E of 14.0x, the STOXX Europe 600 is significantly cheaper than the S&P 500 at 19.2x (figure 4). This rather large gap seems unjustified given: 1) the small and possibly disappearing gap in GDP growth, and 2) the slowing earnings growth of US tech stocks.

Finally, risks are arguably fewer and smaller in Europe. In the EU20, the average government debt is relatively modest at 88% of GDP. Incomes, while lower on average than in the US, are more evenly distributed, and the link between the stock market and the economy is weaker. Finally, European institutions are not at risk of overnight disruption, and European leaders are not picking fights with everyone.

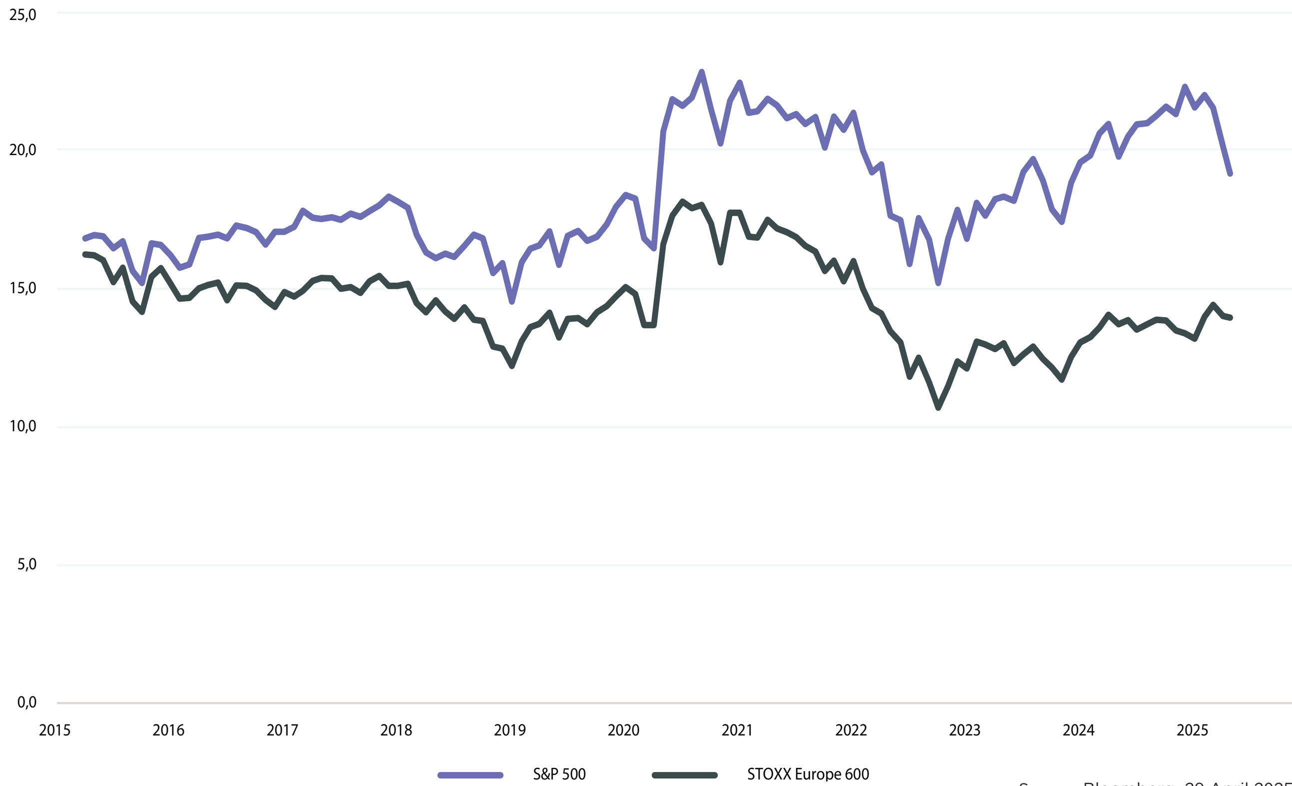
Conclusion

The US stock market has vastly outperformed its European counterpart over the last decade, but this is not due to a considerable difference in broad economic performance. Instead, it is due to US tech firms' strong growth and rising earnings multiples. The 'Frogs, Krauts and Limeys' may not have many big tech firms, but they offer stability. Furthermore, the modest (0.8%-points) gap between US and European GDP may close in the coming year as the US is forced to reduce its budget deficit.

For active managers running concentrated portfolios, Europe offers plenty of high-quality companies to choose from. US investors with a strong domestic focus may want to broaden their horizons and diversify into Europe.

Figure 4

Historical P/E S&P 500 vs. STOXX Europe 600



Source: Bloomberg, 29 April 2025

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