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PUBLIC EQUITIES

European Small Caps: Three Catalysts for Change

INSIGHTS

From changing interest rate expectations to potential political resolutions, there are reasons to believe that European smaller companies may be at a turning point.

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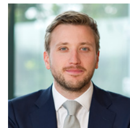

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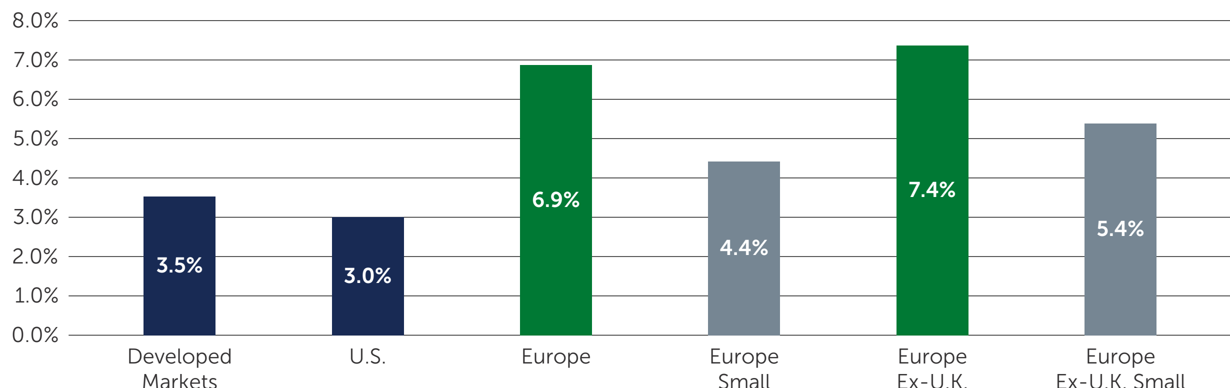
European equities have begun 2025 on a strong footing, outpacing both U.S. and broader developed markets this year **(Figure 1)**. While this outperformance in part reflects both the recent decline in U.S. technology companies and a partial clawback of European equity indices' relative underperformance since 2022, immediate concerns over trade tariffs have diminished.

Figure 1: European Equities Outperform Broader Markets YTD (US$)



Sources: Barings; MSCI; Refinitiv. As of January 31, 2025. For illustrative purposes only. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance.

In addition, relative valuations also support this outperformance. In particular, even globally active and world-leading European companies are currently trading at substantial discounts to their U.S. counterparts.[1] Meanwhile, smaller European companies, which have historically traded at a premium valuation compared to larger European companies, are currently valued on unprecedented discounts across both earnings-based and asset-related measures.[2]

Looking ahead, we believe there are three key themes that could shape a turning point for smaller companies across Europe:

1. INTEREST RATES

Smaller companies' valuations have tracked interest rate expectations.

As rates continue to fall across the Eurozone, we have a catalyst for potential re-rating.

2. POLITICAL RESOLUTION

Following a period of negative growth and a political stalemate, political uncertainty in both France and Germany is likely to result in domestic parties setting out differing visions of growth.

Removal of political uncertainty and higher economic investment could reinvigorate the opportunity in smaller companies.

3. UKRAINE CEASEFIRE

Risk sentiment for Europe has undoubtably been impacted by a return of war to the continent.

Small caps are more positively geared to a ceasefire due to their higher proportion of domestic facing earnings, and the perception that they are more correlated to European GDP.

1. Source: MSCI Europe Next 12 months PE Relative to MSCI U.S.A. As of January 31, 2025.
2. Source: MSCI. As of January 31, 2025.

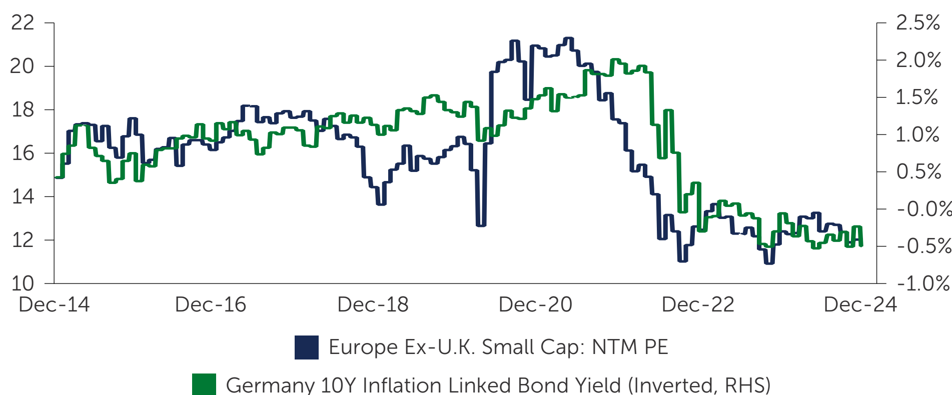
1. INTEREST RATES

What Can Go Up, Can Come Down

Looking at the near-term drivers, it remains clear that risk assets such as smaller companies have historically tracked interest rate expectations **(Figure 2)**. This is based on the perception that smaller companies are more cyclical and economically exposed given their exposure to a higher proportion of floating-rate debt.

Encouragingly, indebtedness among smaller companies has been falling, improving their ability to service debt.[3] In addition, as interest rates have now begun to fall across the Eurozone, there is a catalyst for a potential re-rating.

Figure 2: Smaller Companies' Valuations Have Tracked Interest Rate Expectations



Source: Barings. As of December 31, 2024. Based on respective MSCI indices. For illustrative purposes only. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance.

2. POLITICAL RESOLUTION

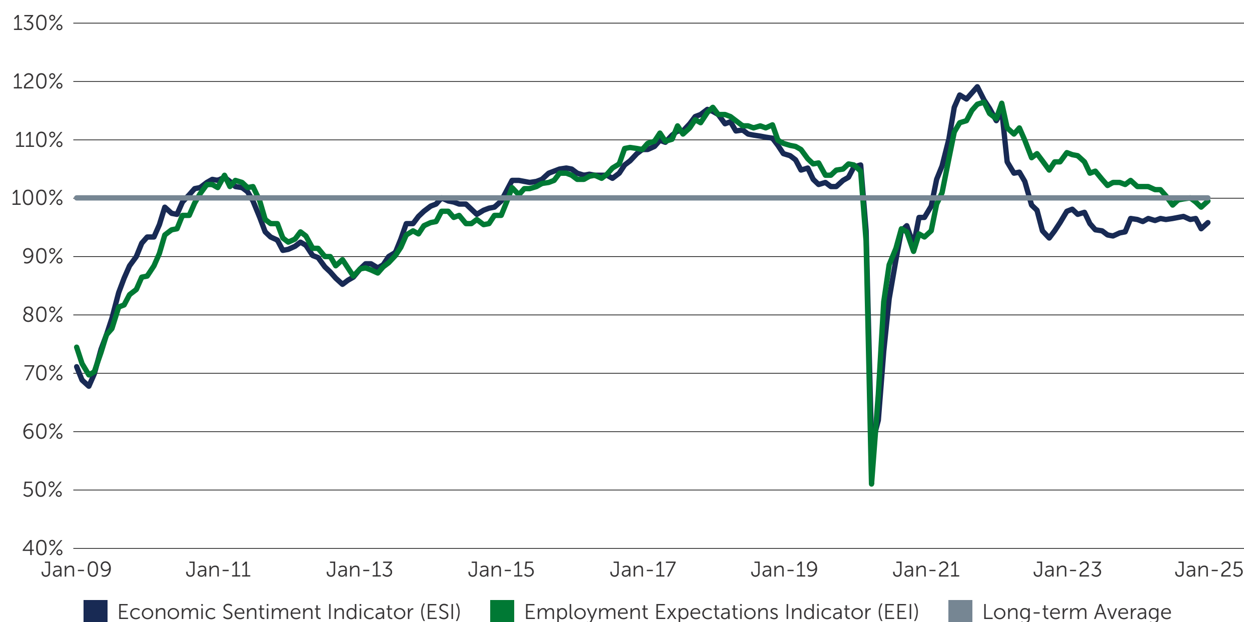
Competing Visions for Economic Growth

While France and Germany have been seen as the Eurozone's most prominent leaders and growth engines, both nations have had to contend with domestic challenges. At the same time, rising protectionism in both the U.S. and China and increasing energy costs have exacerbated competitive challenges, discouraged investment and pressured corporate profitability. Elections in both France and Germany have added additional uncertainty around the outlook for budgets, taxation and reforms, resulting in falling consumer confidence and weakening employment prospects.

3. Source: MSCI Europe ex U.K. Index Net Debt to EBITDA ratio over time. As of January 2025.

Against this backdrop, consumers have reacted by saving more, with household savings rates in the Eurozone now close to a three-year high. Any improvement or stabilization of the political picture would likely support the unlocking of pent-up demand.

Figure 3: EU Economic Sentiment & Employment Expectations



Sources: European Commission Services; Economic Sentiment Indicators. As of January 31, 2025.

Taking a closer look, France remains mired in a political stalemate, initiated by President Macron's gamble to call snap elections in a bid to shore up his support in parliament. The outcome was a "hung" National Assembly divided between three roughly equally represented and politically incompatible factions. The resulting caretaker French government has had very little room to act, with each faction setting out their own competing visions for France while a growing fiscal deficit looms large. While a short-term budget has been approved, investors remain concerned that unfunded spending plans—whether from the left or right of the political spectrum—could increase France's deficit, ultimately transgressing Eurozone limits. As it stands, it remains far from clear what sort of coalition will eventually emerge to effectively govern, and how stable and viable it will be. Nevertheless, any resolution would reduce uncertainty, benefiting investor sentiment to not only France but the Eurozone more broadly.

In Germany, meanwhile, the recent elections took place at a time where growth over the last couple of years has been sluggish. Slow economic growth in part reflects ballooning energy costs—particularly problematic in a nation where manufacturing still accounts for 20% of gross value added, while Germany's exports to China have faced increased domestic competition, with domestic brands now representing more than 60% of the passenger vehicle market.[4] In this context, a shaky political coalition has failed to successfully address key issues such as employment and pension reform, or energy policy and defence spending, leaving consumers concerned and voters dissatisfied.

4. Sources: China Association of Automobile Manufacturers; Market Share Data. As of February 2025.

Looking at the potential for reform, the Bundesbank, International Monetary Fund, the Organization for Economic Cooperation and Development, Germany's biggest trade union, and its state-appointed council of economic experts, agree that Germany's "debt brake" is no longer serving the country well. The debt brake, which was implemented under Angela Merkel in 2009, is a German constitutional rule that limits the federal government's annual deficit to 0.35% of GDP, after adjusting for the economic cycle, while preventing Germany's 16 states from borrowing at all. Changes to this restrictive regime will depend on stronger leadership, however, the center right Christian Democratic candidate Friedrich Merz, the incoming chancellor, had on the campaign trail hinted at an easing of these constraints. While any changes to the debt brake are likely to be evolution rather than revolution, higher investment in areas such as infrastructure, energy production and defence should reduce uncertainty and likely lower risk premiums, while allowing businesses a stable foundation to allocate capital.

3. UKRAINE CEASEFIRE

Removal of a Continental Cliff Edge

Three years after Russia's invasion, the fighting in Ukraine remains a grinding attritional conflict. Against the backdrop of war, talks of a ceasefire have increased following the inauguration of President Trump, who took office with a vow to end the war in Ukraine. While Kyiv has in the past refused to cede any territory, Ukrainian president Zelensky looks to have softened his stance given fatigue and realpolitik. At the same time, talk of a ceasefire has caused diplomatic disruption across Europe—and the implications of such an event are broad.

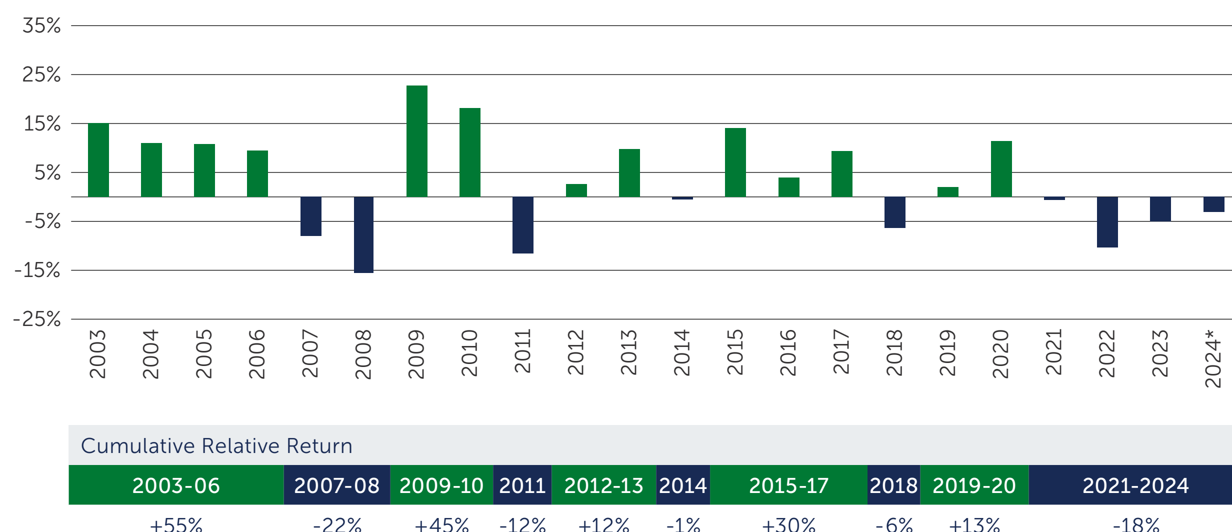
From our perspective, a ceasefire could support European small caps in three key areas. Firstly, in the immediate aftermath, a lowering of risk sentiment in Europe would lift European valuations, with risk assets such as smaller companies likely to benefitting disproportionally. Secondly, a resolution would likely reduce energy prices in Europe, benefitting both the consumer and industry, with Germany's Eastern European production hubs looking partially exposed to the upside. In addition, upward revisions to growth expectations could encourage investment and improve sentiment. Smaller companies have a higher proportion of sales and earnings generated domestically, and their relative performance is positively correlated to both European GDP growth and industrial activity. As a result, a ceasefire could potentially lead European smaller companies materially higher.

Valuations: An Attractive Entry Point into a Long-term Opportunity

Amid the geopolitical challenges of the last few years, smaller companies have underperformed their larger peers in Europe by a margin only last seen during the Global Financial Crisis (GFC). That said, after the GFC, this underperformance was followed by a period of pronounced outperformance in the asset class during 2009 and 2010 from both a relative and absolute basis **(Figure 4)**. While not without risk, however, we believe this suggests smaller companies have the potential for outperformance relative to larger companies in the coming years.

Valuations, both in absolute terms and relative to other asset classes, also offer support for smaller companies, with the price-to-earnings and price-to-book measures indicating European smaller companies' valuations are at decade lows relative to history and to larger companies.[5]

Figure 4: Relative Performance of Europe Ex-U.K. Smaller Companies vs. Large Cap



Cumulative Relative Return									
2003-06	2007-08	2009-10	2011	2012-13	2014	2015-17	2018	2019-20	2021-2024
+55%	-22%	+45%	-12%	+12%	-1%	+30%	-6%	+13%	-18%

Sources: European Commission Services; Economic Sentiment Indicators. As of January 31, 2025.

Key Takeaway

Looking across the European equities market, potentially compelling opportunities exist in smaller companies. In particular, we believe there are three key themes that are likely to support the asset class going forward: changes in interest rate expectations, the potential for the removal of overhangs from Germany's political impasse, and a potential ceasefire in Ukraine.

That said, with a number of risks and unknowns on the horizon, volatility is likely to remain elevated. For this reason, we believe fundamental, bottom-up stock selection remains crucial. In addition, active managers with significant breadth and resources will be particularly well-positioned to uncover opportunities as they emerge across European small caps.

5. Source: MSCI Europe ex U.K. Next 12 months PE Relative to MSCI Europe ex U.K. As of January 31, 2025.

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