J.P.Morgan

INVESTMENT INSIGHTS

The secrets of European small caps' success

Global equity investors seem tired of Europe and all its political risk. But small caps are a different story.

The global equity investor base seems to have lost faith in Europe amid a procession of political risks. First Grexit. Then Brexit.

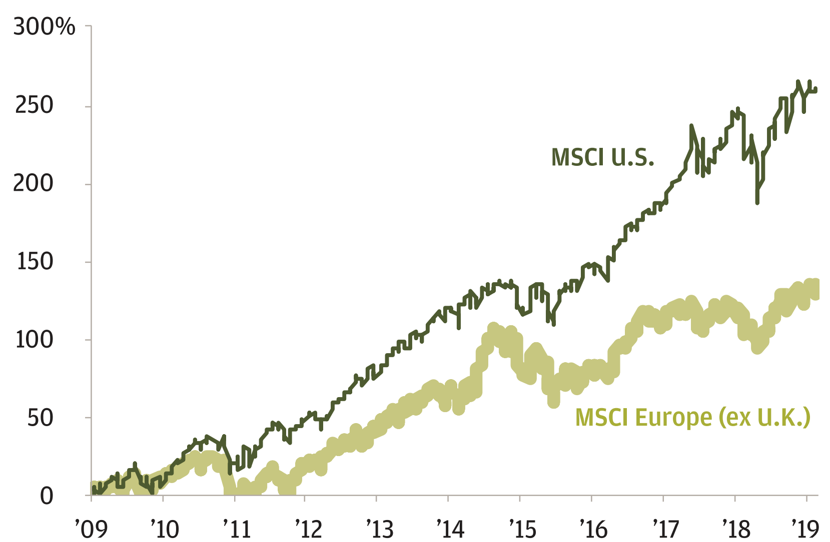
Will EU-skepticism engulf more countries in the years to come, dampening investor sentiment? Not likely, if investors pay attention to how well the euro area's small- and mid-cap equities are doing. Despite the European equity index's lackluster performance, small caps, as well as private equity, are having often overlooked success.

WHY BOTHER OWNING EUROPE?

In terms of price action in the broad market, the aversion to European equities has merit. Over the last 10 years, Europe has persistently lagged its counterpart across the pond (Figure 1). Owning European stocks hasn't made for a less volatile ride, either. Realized annual volatility in European equities has averaged 17% versus 15% in the United States.

FIGURE 1: FOR A DECADE, EQUITIES IN EUROPE HAVE LAGGED THOSE IN THE UNITED STATES, IN RETURNS AND EARNINGS

Cumulative total returns (Sep. 2009–Oct. 2019)



Source: Bloomberg. Data as of October 2019. Returns are in local currency terms.

INVESTMENT AND INSURANCE PRODUCTS ARE: • NOT FDIC INSURED • NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY • NOT A DEPOSIT OR OTHER OBLIGATION OF, OR GUARANTEED BY, JPMORGAN CHASE BANK, N.A. OR ANY OF ITS AFFILIATES • SUBJECT TO INVESTMENT RISKS, INCLUDING POSSIBLE LOSS OF THE PRINCIPAL AMOUNT INVESTED

To be clear, it is not the case that after lagging the United States for so many years, European stocks now look cheap and therefore attractive. The gap in earnings practically mirrors the gap in returns (Figure 2).

Lower absolute returns and higher volatility add up to a portfolio construction nightmare. Why bother owning Europe at this point?

Our analysis here attempts to answer this question. It shows that, although U.S. and European market returns have followed different trajectories, their economies really haven't. The key insight is that market returns in Europe vary significantly depending on the implementation vehicle. Our conclusion—we recommend small- and mid-cap stocks, and private equity exposure, rather than large caps, as the latter are more reflective of global and emerging market (EM) risk, and are likely to remain so.

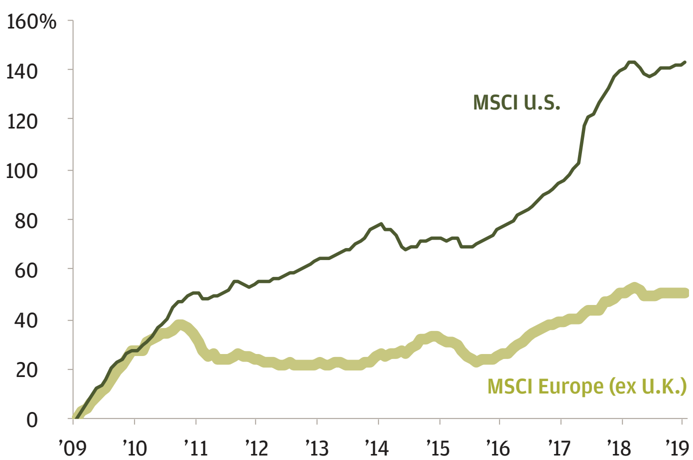
MIND THE GAP: EUROPEAN MARKETS VS. THE ECONOMY

Public equity performance in Europe poses a conundrum. How can it be that the stock markets in Europe and the United States have gone on such starkly different paths when their economies haven't? After all, the two regions have experienced similar real GDP growth dynamics over the last 10 years, with the United States outpacing by only nine percentage points cumulatively. Moreover, that GDP gap can be almost entirely traced to demographics; from the standpoint of economic productivity, the experiences of the United States and Europe have been almost identical. (See Figure 3 on U.S. and euro area growth and productivity.)

Shouldn't the performance of a country's stock market reflect economic activity on the ground? How can it be that the earnings gap between the United States and Europe is so much bigger than the GDP/productivity gap?

FIGURE 2: FOR A DECADE, EQUITIES IN EUROPE HAVE LAGGED THOSE IN THE UNITED STATES, IN RETURNS AND EARNINGS

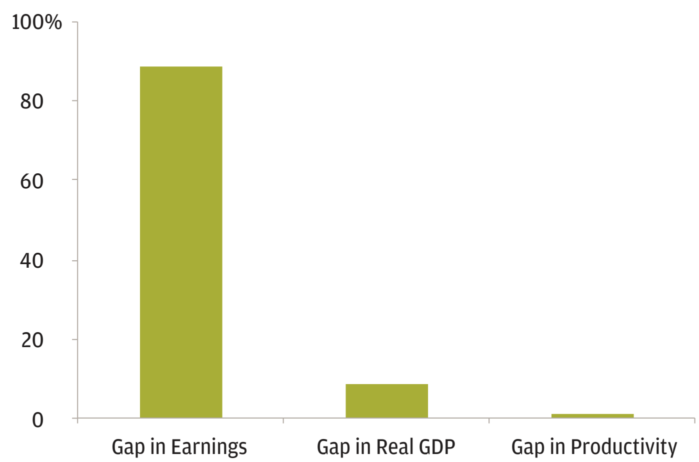
Cumulative earnings per share (EPS) returns (Sep. 2009–Sep. 2019)



Source: Bloomberg. Data as of September 2019. Rolling 12fwd Bloomberg Best EPS.

FIGURE 3: U.S. AND EURO AREA GROWTH AND PRODUCTIVITY: NEARLY IDENTICAL

Cumulative percentage gap between the United States and euro area (last 10 years)



Source: Bloomberg, European Commission. Data as of Q2 2019.

To understand the large and growing gap between U.S. and European equity markets, we need to examine the dynamics of small-cap companies. In fact, small-cap stocks in Europe have, by and large, kept up with the U.S. market (Figure 4). The small-cap experience tells us that whatever is driving the broad market gap is specific to, and is inhibiting, Europe's larger companies. Indeed, over the last 10 years, if you make the apples-to-apples comparison of small-cap-to-small-cap, European stocks have actually performed better—on a volatility-adjusted basis—than their U.S. counterparts. (This conclusion is based on a comparison of 10-year small-cap Sharpe ratios 0.90 for Europe versus 0.85 for the United States.)

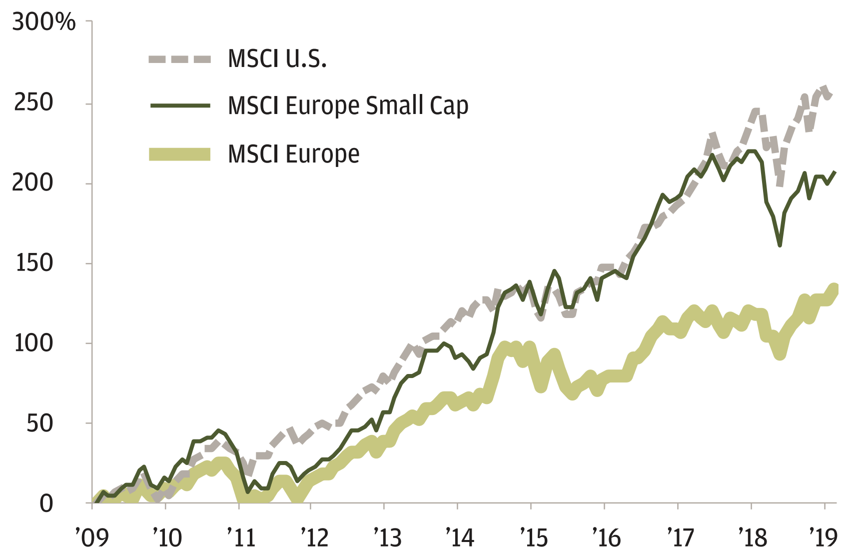
When we zoom in to examine performance at the sector level, we find three key takeaways that help explain the difference between the performances of Europe's small- and large-cap stocks:

1. Cyclical sectors have generated far superior returns for small-cap stocks.
2. Small caps have a much greater exposure (13.5x) to real estate, which has been booming in Northern Europe—especially in Germany, where real home prices have been appreciating an average of 5% per annum in recent years.
3. Smalls caps have a slightly greater exposure to the technology sector, which continues to benefit from a strong secular tailwind—again especially in Germany, where Berlin, in particular, is emerging as the Silicon Valley of Europe.

The cumulative outperformance chart (Figure 5) summarizes these three focal points, quantifying how each contributed to European small caps' relative outperformance over large.

FIGURE 4: EUROPEAN SMALL CAPS HAVE FAR OUTPERFORMED THE INDEX

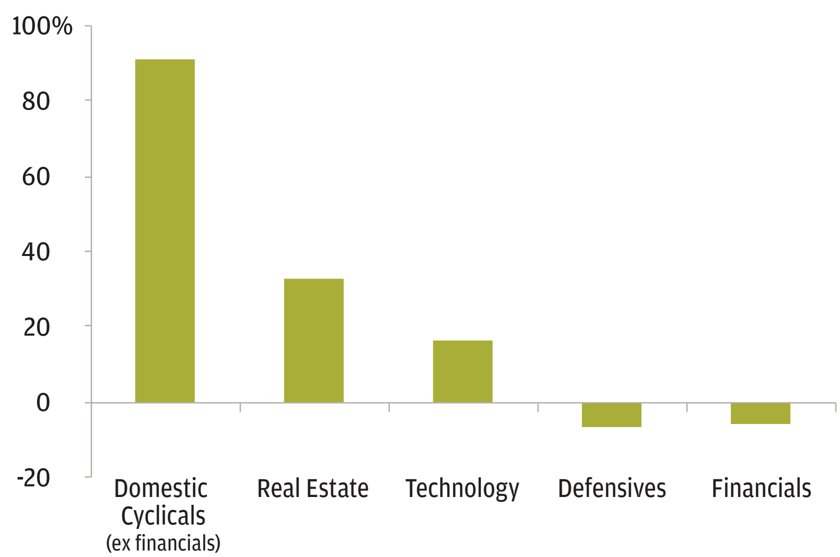
Cumulative total return, % (Sep. 2009–Sep. 2019)



Source: Bloomberg. Data as of September 2019. Data is in local currency terms. Both European indices exclude the United Kingdom.

FIGURE 5: CUMULATIVE OUTPERFORMANCE OF EUROPEAN SMALL CAP OVER LARGE CAP

(Sep. 2009–Sep. 2019)



Source: Bloomberg. Data as of September 2019. Domestic cyclicals include: Industrials, Materials, Consumer Discretionary, Energy. Defensives include: Healthcare, Utilities and Consumer Staples. European index excludes the United Kingdom. Both series are in local currency terms.

It's noteworthy that the financial sector hasn't been a big swing factor. This fact contradicts the popular belief that negative interest rates in Europe have held back a recovery by hurting bank profitability. The drag on the banks may have had some effect, but it hasn't had a material impact on overall credit growth in Europe, especially not in the North. Over the last 10 years, credit growth has actually been stronger in Northern Europe than in the United States (Figure 6).

SMALL, DOMESTIC-FOCUSED EQUITIES HAVE PERFORMED BETTER HISTORICALLY

The reality is that large-cap stocks in Europe just aren't a good reflection of domestic economic activity on the ground. They are more reflective of global and emerging market dynamics, which have been persistently weak since 2010.

One way to drive this point home is to look at *where* companies geographically source their revenue. According to FactSet, small-cap companies in Europe source only a quarter of their revenues from outside Europe; for large-cap companies this number jumps to more than half.

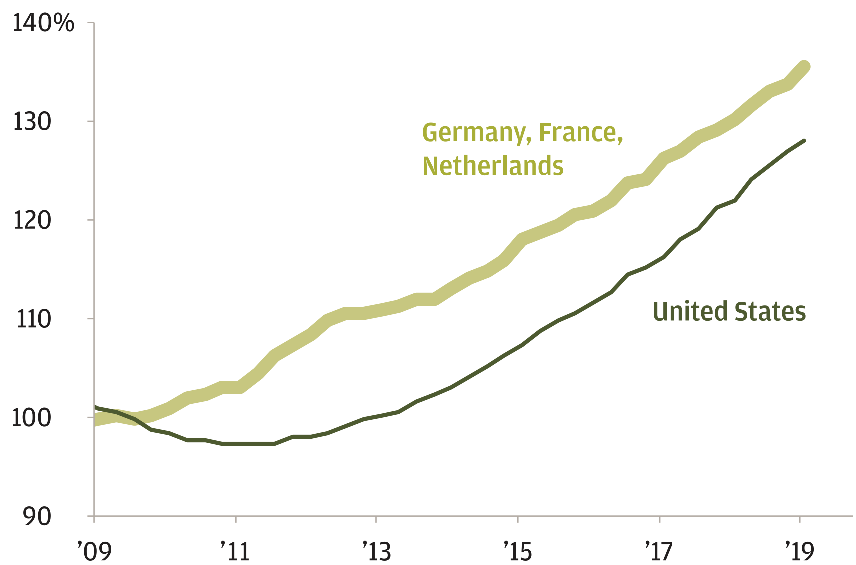
To take the thesis further: If small caps are close to the domestic economy in Europe, then private equity is likely even closer. Admittedly, we do not have data on European private companies' revenue sources. But performance suggests it is within the region (Figure 7).

According to KKR, the stellar performance of European private equity in recent years has been driven by exposure to companies focused on enhancing consumer experiences and generating technological upgrades. In addition, KKR sees a strong tailwind for private real estate opportunities in Europe, particularly in the multifamily and student housing sectors.[1]

These are exactly the types of risk an equity investor should want to own in Europe: small, domestic and intertwined with the sectors that have the greatest earnings potential.

FIGURE 6: CREDIT GROWTH IN NORTHERN EUROPE HAS OUTPACED THAT OF THE UNITED STATES

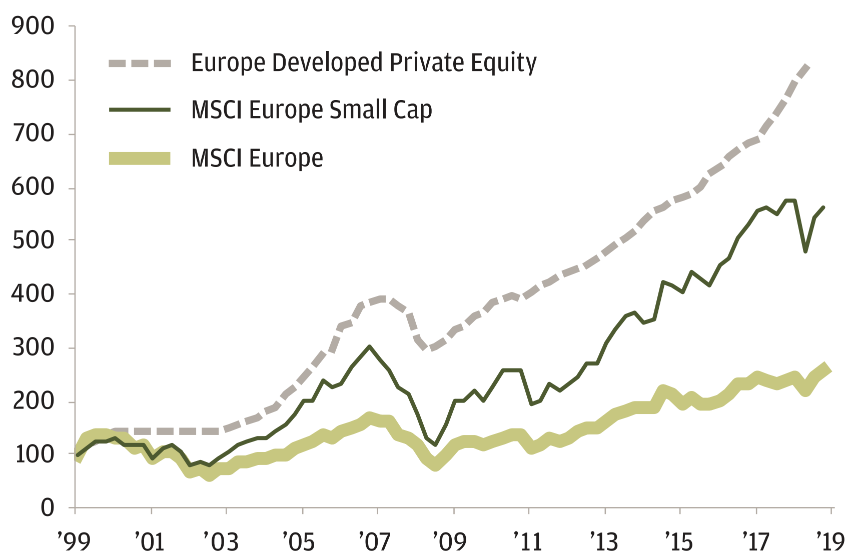
Credit to private non-financial sector, 2009 = 100



Source: BIS. Data as of Q1 2019.

FIGURE 7: THE SMALLER AND MORE DOMESTIC, THE BETTER THE PERFORMANCE

Total returns, Index 1999 = 100



Source: Cambridge Associates, Bloomberg. Data as of June 2019. All returns are in euros. PE returns are net of fees, expenses and carried interest. MSCI Indices exclude the United Kingdom.

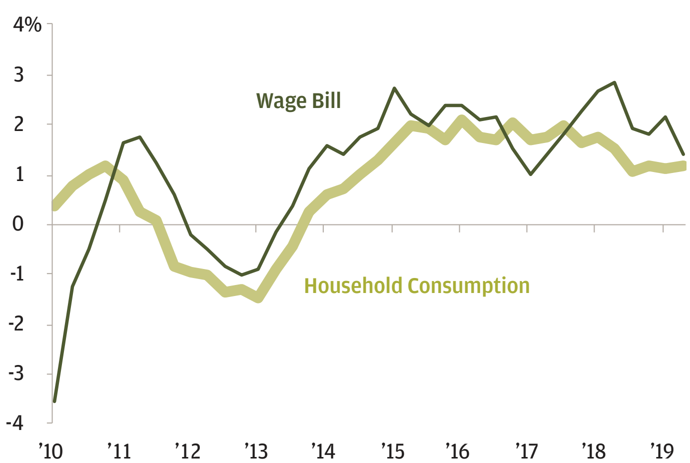
[1] "Insights: Global Macro Trends—Hot Spots," KKR Global Institute (August 2019), https://www.kkr.com/sites/default/files/KKR_Whitepaper_54_1908.pdf?utm_source=Public+Affairs&utm_medium=Press+Release&utm_campaign=Hot+Spots&utm_term=Hot+Spots&utm_content=Insights+Paper+PDF.

CAN IT CONTINUE?

At first, you might be scared away by headline GDP growth in Europe, which has declined from more than 2.5% in 2017 to around 1% today. However, the headline numbers have been heavily influenced by external sectors that were propelled by strength in global trade in 2017 (as China's economy accelerated) and then, more recently, caught up in its weakness (due, in part, to the U.S.-China tariff war). Yet, all the while, Europe's domestic economy has exhibited stable growth: Domestic demand keeps chugging along at around a 2% pace, driven by a solid labor market and improving consumer fundamentals. Figure 8 illustrates that labor income and consumption have held remarkably steady over the past five years.

FIGURE 8: EUROPE'S LABOR MARKET IS SOLID, SUPPORTING DOMESTIC DEMAND

% YoY

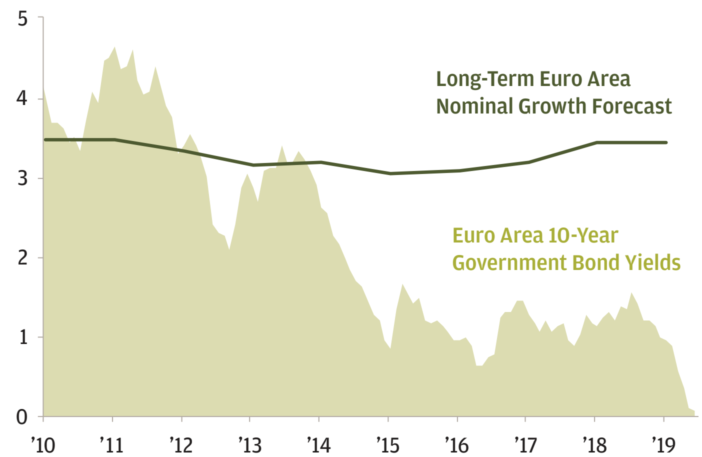


Source: Eurostat. Data as of Q2 2019. Wage bill is a product of employment and real wage growth.

A key reason for the sustained expansion in Europe's domestic economy is the accommodative monetary policy stance engineered by the European Central Bank (ECB). Through a combination of negative policy rates and quantitative easing, the ECB has been able to push longer-term borrowing costs in Europe well below expected broad-economy returns, generating a sustained releveraging of the domestic economy (Figure 9). Meanwhile, inflation dynamics in Europe remain generally muted, as slack is still very apparent in product and labor markets.

FIGURE 9: THE ECB HAS SUCCESSFULLY PUSHED BORROWING COSTS FAR BELOW GROWTH EXPECTATIONS

%

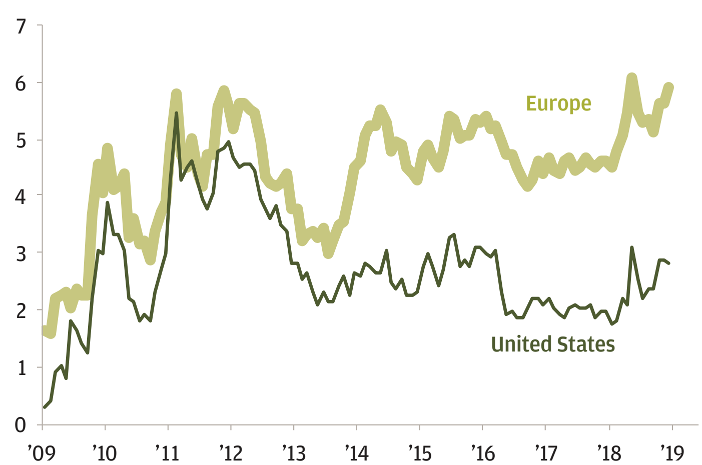


Source: IMF, ECB. Data as of September 2019.

These conditions make a healthy macroeconomic backdrop for equity investing. European small caps continue to exhibit a much wider equity risk premium (which acts as a buffer) than their U.S. counterparts (Figure 10). Furthermore, the ECB is likely to keep monetary policy very accommodative for years into the future. At current pricing, the rates market doesn't see the ECB achieving a positive policy rate until 2026.

FIGURE 10: AS A BUFFER, EUROPE HAS A MORE ATTRACTIVE EQUITY RISK PREMIUM

Small-cap equity risk premium, %



Source: Bloomberg, FRB, ECB. Data as of September 2019. Equity risk premium is defined as the inverse of the price-to-earnings ratio minus the 10-year, risk-free rate. Europe excludes the United Kingdom.

Lastly and more fundamentally, trends in industry concentration may even favor European small caps over their U.S. counterparts. Over the last 20 years, industry concentration has been rising in the United States, due to a combination of lax anti-trust regulation and the structure of the U.S. capital markets. Europe hasn't experienced a similar rise in concentration[2]—which matters, because in a concentrated market, large companies' success often comes at smaller companies' expense.

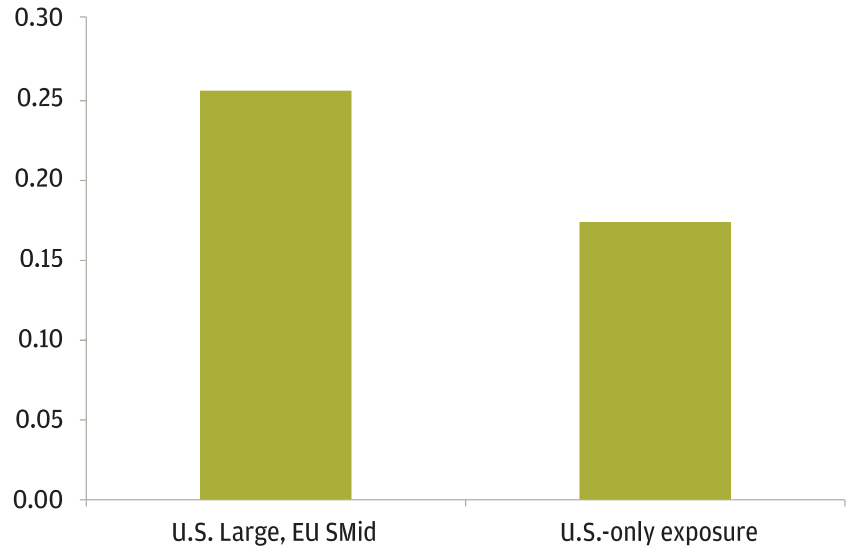
In this vein, an effective barbell strategy that has been fruitful over the last five years involves maintaining U.S. large-cap exposure but replacing U.S. small- and mid-cap exposure with European equivalents. From a volatility-adjusted standpoint, this barbell has been superior to U.S.-only positioning (Figure 11).

In the end, this result should not be very surprising, given that geographic diversification offers investment portfolios well-known, well-established benefits. The enhancement comes from combining performing assets that are relatively uncorrelated. It's a trivial point, but an important one: Figure 12 illustrates how much less correlated European small- and mid-cap stocks are to U.S. large caps, when compared with U.S.-only positioning.

Speak with your J.P. Morgan representative about these and other investment insights.

FIGURE 11: A BARBELL INCORPORATING SMALL- AND MID-CAP EUROPEAN EXPOSURE HAS BEEN SUPERIOR TO U.S.-ONLY EXPOSURE

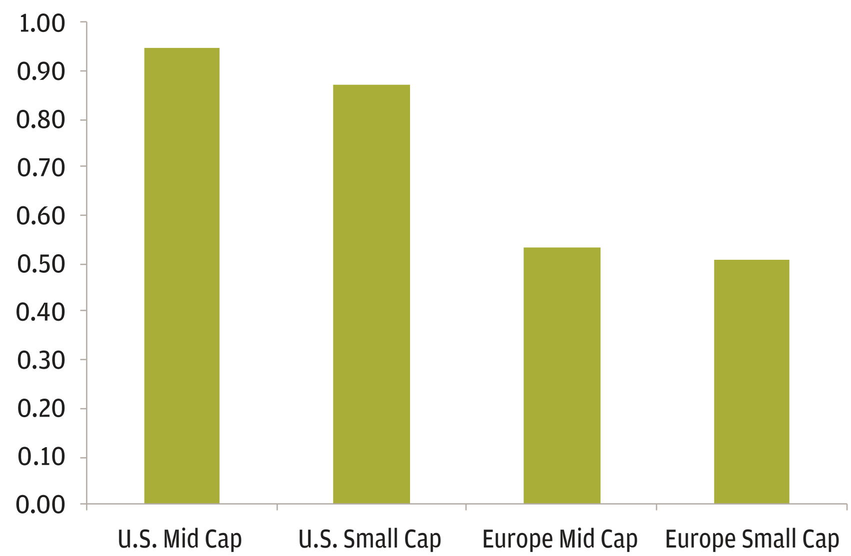
Average monthly Sharpe ratio (2014–2109)



Source: Bloomberg. Data as of September, 2019. The weightings for both portfolios are 50% large cap, 25% mid cap and 25% small cap.

FIGURE 12: PORTFOLIOS CAN GAIN A DIVERSIFICATION BENEFIT BECAUSE EUROPEAN SMALL AND MID CAPS ARE RELATIVELY UNCORRELATED TO U.S. LARGE CAPS

Monthly correlations of returns, each bar is relative to U.S. large cap



Source: Bloomberg. Data as of September, 2019.

[2] Germán Gutiérrez and Thomas Philippon, "How EU Markets Became More Competitive Than U.S. Markets: A Study of Institutional Drift," NBER Working Paper No. 24700 (June 2019), https://www.weforum.org/agenda/2018/10/are-eu-markets-more-competitive-than-those-in-the-u-s.

IMPORTANT INFORMATION

Key Risks

This material is for informational purposes only, and may inform you of certain products and services offered by J.P. Morgan's wealth management businesses, part of JPMorgan Chase & Co. ("JPM"). **Please read all Important Information.**

The price of equity securities may rise or fall due to the changes in the broad market or changes in a company's financial condition, sometimes rapidly or unpredictably. Equity securities are subject to "stock market risk" meaning that stock prices in general may decline over short or extended periods of time.

General Risks & Considerations

Any views, strategies or products discussed in this material may not be appropriate for all individuals and are subject to risks. **Investors may get back less than they invested, and past performance is not a reliable indicator of future results.** Asset allocation/diversification does not guarantee a profit or protect against loss. Nothing in this material should be relied upon in isolation for the purpose of making an investment decision. You are urged to consider carefully whether the services, products, asset classes (e.g., equities, fixed income, alternative investments, commodities, etc.) or strategies discussed are suitable to your needs. You must also consider the objectives, risks, charges and expenses associated with an investment service, product or strategy prior to making an investment decision. For this and more complete information, including discussion of your goals/situation, contact your J.P. Morgan representative.

Non-Reliance

Certain information contained in this material is believed to be reliable; however, JPM does not represent or warrant its accuracy, reliability or completeness, or accept any liability for any loss or damage (whether direct or indirect) arising out of the use of all or any part of this material. No representation or warranty should be made with regard to any computations, graphs, tables, diagrams or commentary in this material, which are provided for illustration/reference purposes only. The views, opinions, estimates and strategies expressed in this material constitute our judgment based on current market conditions and are subject to change without notice. JPM assumes no duty to update any information in this material in the event that such information changes. Views, opinions, estimates and strategies expressed herein may differ from those expressed by other areas of JPM, views expressed for other purposes or in other contexts, and **this material should not be regarded as a research report**. Any projected results and risks are based solely on hypothetical examples cited, and actual results and risks will vary depending on specific circumstances. Forward-looking statements should not be considered as guarantees or predictions of future events.

Nothing in this document shall be construed as giving rise to any duty of care owed to, or advisory relationship with, you or any third party. Nothing in this document shall be regarded as an offer, solicitation, recommendation or advice (whether financial, accounting, legal, tax or other) given by J.P. Morgan and/or its officers or employees, irrespective of whether or not such communication was given at your request. J.P. Morgan and its affiliates and employees do not provide tax, legal or accounting advice. You should consult your own tax, legal and accounting advisors before engaging in any financial transactions.

Legal Entity, Brand & Regulatory Information

In the **United States**, bank deposit accounts and related services, such as checking, savings and bank lending, are offered by **JPMorgan Chase Bank, N.A.** Member FDIC.

JPMorgan Chase Bank, N.A. and its affiliates (collectively **"JPMCB"**) offer investment products, which may include bank-managed investment accounts and custody, as part of its trust and fiduciary services. Other investment products and services, such as brokerage and advisory accounts, are offered through **J.P. Morgan Securities LLC ("JPMS")**, a member of FINRA and SIPC. JPMCB and JPMS are affiliated companies under the common control of JPM. Products not available in all states.

In **Luxembourg**, this material is issued by J.P. Morgan Bank Luxembourg S.A. (JPMBL), with registered office at European Bank and Business Centre, 6 route de Treves, L-2633, Senningerberg, Luxembourg. R.C.S Luxembourg B10.958. Authorized and regulated by Commission de Surveillance du Secteur Financier (CSSF) and jointly supervised by the European Central Bank (ECB) and the CSSF. J.P. Morgan Bank Luxembourg S.A. is authorized as a credit institution in accordance with the Law of 5th April 1993. In the **United Kingdom**, this material is issued by J.P. Morgan Bank Luxembourg S.A., London Branch. Prior to Brexit (Brexit meaning that the United Kingdom leaves the European Union under Article 50 of the Treaty on European Union, or, if later, loses its ability to passport financial services between the United Kingdom and the remainder of the EEA), J.P. Morgan Bank Luxembourg S.A., London Branch is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority. Details about the extent of our regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from us on request. In the event of Brexit, in the United Kingdom, J.P. Morgan Bank Luxembourg S.A., London Branch is authorized by the Prudential Regulation Authority, subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. In **Spain**, this material is distributed by J.P. Morgan Bank Luxembourg S.A., Sucursal en España, with registered office at Paseo de la Castellana, 31, 28046 Madrid, Spain. J.P. Morgan Bank Luxembourg S.A., Sucursal en España is registered under number 1516 within the administrative registry of the Bank of Spain and supervised by the Spanish Securities Market Commission (CNMV). In **Germany**, this material is distributed by J.P. Morgan Bank Luxembourg S.A., Frankfurt Branch, registered office at Taunustor 1 (TaunusTurm), 60310 Frankfurt, Germany, jointly supervised by the Commission de Surveillance du Secteur Financier (CSSF) and the European Central Bank (ECB), and in certain areas also supervised by the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin). In **Italy**, this material is distributed by J.P. Morgan Bank Luxembourg S.A., Milan Branch, registered office at Via Cantena Adalberto 4, Milan 20121, Italy and regulated by Bank of Italy and the Commissione Nazionale per le Società e la Borsa (CONSOB). In addition, this material may be distributed by **JPMorgan Chase Bank, N.A. ("JPMCB"), Paris branch,** which is regulated by the French banking authorities Autorité de Contrôle Prudentiel et de Résolution and Autorité des Marchés Financiers or by **J.P. Morgan (Suisse) S.A.**, which is regulated in Switzerland by the Swiss Financial Market Supervisory Authority (FINMA).

In **Hong Kong**, this material is distributed by **JPMCB, Hong Kong branch**. JPMCB, Hong Kong branch is regulated by the Hong Kong Monetary Authority and the Securities and Futures Commission of Hong Kong. In Hong Kong, we will cease to use your personal data for our marketing purposes without charge if you so request. In **Singapore**, this material is distributed by **JPMCB, Singapore branch**. JPMCB, Singapore branch is regulated by the Monetary Authority of Singapore. Dealing and advisory services and discretionary investment management services are provided to you by JPMCB, Hong Kong/Singapore branch (as notified to you). Banking and custody services are provided to you by JPMCB Singapore Branch. The contents of this document have not been reviewed by any regulatory authority in Hong Kong, Singapore or any other jurisdictions. You are advised to exercise caution in relation to this document. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice. For materials which constitute product advertisement under the Securities and Futures Act and the Financial Advisers Act, this advertisement has not been reviewed by the Monetary Authority of Singapore. JPMorgan Chase Bank, N.A. is a national banking association chartered under the laws of the United States, and as a body corporate, its shareholder's liability is limited.

With respect to countries in **Latin America**, the distribution of this material may be restricted in certain jurisdictions. We may offer and/or sell to you securities or other financial instruments which may not be registered under, and are not the subject of a public offering under, the securities or other financial regulatory laws of your home country. Such securities or instruments are offered and/or sold to you on a private basis only. Any communication by us to you regarding such securities or instruments, including without limitation the delivery of a prospectus, term sheet or other offering document, is not intended by us as an offer to sell or a solicitation of an offer to buy any securities or instruments in any jurisdiction in which such an offer or a solicitation is unlawful. Furthermore, such securities or instruments may be subject to certain regulatory and/or contractual restrictions on subsequent transfer by you, and you are solely responsible for ascertaining and complying with such restrictions. To the extent this content makes reference to a fund, the Fund may not be publicly offered in any Latin American country, without previous registration of such fund's securities in compliance with the laws of the corresponding jurisdiction. Public offering of any security, including the shares of the Fund, without previous registration at Brazilian Securities and Exchange Commission—CVM is completely prohibited. Some products or services contained in the materials might not be currently provided by the Brazilian and Mexican platforms.

JPMorgan Chase Bank, N.A. (JPMCBNA) (ABN 43 074 112 011/AFS Licence No: 238367) is regulated by the Australian Securities and Investment Commission and the Australian Prudential Regulation Authority. Material provided by JPMCBNA in Australia is to "wholesale clients" only. For the purposes of this paragraph the term "wholesale client" has the meaning given in section 761G of the Corporations Act 2001 (Cth). Please inform us if you are not a Wholesale Client now or if you cease to be a Wholesale Client at any time in the future.

JPMS is a registered foreign company (overseas) (ARBN 109293610) incorporated in Delaware, U.S.A. Under Australian financial services licensing requirements, carrying on a financial services business in Australia requires a financial service provider, such as J.P. Morgan Securities LLC (JPMS), to hold an Australian Financial Services Licence (AFSL), unless an exemption applies. **JPMS is exempt from the requirement to hold an AFSL under the Corporations Act 2001 (Cth) (Act) in respect of financial services it provides to you, and is regulated by the SEC, FINRA and CFTC under U.S. laws, which differ from Australian laws.** Material provided by JPMS in Australia is to "wholesale clients" only. The information provided in this material is not intended to be, and must not be, distributed or passed on, directly or indirectly, to any other class of persons in Australia. For the purposes of this paragraph the term "wholesale client" has the meaning given in section 761G of the Act. Please inform us immediately if you are not a Wholesale Client now or if you cease to be a Wholesale Client at any time in the future.

This material has not been prepared specifically for Australian investors. It:

- May contain references to dollar amounts which are not Australian dollars;
- May contain financial information which is not prepared in accordance with Australian law or practices;
- May not address risks associated with investment in foreign currency denominated investments; and
- Does not address Australian tax issues.

References to "J.P. Morgan" are to JPM, its subsidiaries and affiliates worldwide. "J.P. Morgan Private Bank" is the brand name for the private banking business conducted by JPM.

This material is intended for your personal use and should not be circulated to or used by any other person, or duplicated for non-personal use, without our permission. If you have any questions or no longer wish to receive these communications, please contact your J.P. Morgan representative.