



Corporate &
Investment Banking

EUROPE

QIS Tactical

31 March 2005
(15:00 CET)

European Exceptionalism

End of US exceptionalism? The consensus expectation at the start of 2025 was for this to be a year of US exceptionalism, but market performance has been to the contrary. In Europe, value has performed strongly YtD, with a notably robust performance from European banking stocks. For the past two years, US equities have delivered >20% returns each year. This is a very rare occurrence outside the late 1990s, and has only happened twice in the past 100 years; in both instances, cumulative returns in the subsequent two years were negative. 2025 is shaping up to be a year of rebalancing and we expect this trend to continue. The FOMC assessment of US growth downside risk paints a gloomy picture for the US economy and thus risk assets, in our view.

Positioning is key here. We believe positioning is still overweight the US and underweight Europe, as evidenced by the futures open interest on the SX5E Index, which remains near 20-year lows. Positioning and sentiment are improving in favour of non-US assets, but we believe we are only at the beginning of the reallocation trade. The valuation gap between US and non-US assets is still wide with pre-Covid averages, and we believe the next leg of the European exceptionalism trade is likely to be driven by fundamentals, with US growth slowing and European growth momentum improving.

Valuation gap remains. Despite the near 20% outperformance of European equities since the US election, the valuation gap between Europe and the US remains. US equities have de-rated since the start of the year, although valuations remain high compared to the pre-Covid era. In addition, the valuation gap between Europe and the US remains c.10% higher compared to the pre-Covid average. So even as European equities have significantly outperformed, they are by no means expensive. While the initial phase of European exceptionalism trade has been driven by valuation convergence, we believe the next leg will be driven by fundamental convergence.

Fundamental convergence next. The latest FOMC meeting saw the Fed revising US growth expectations lower and inflation expectations higher. This was largely anticipated, although the most compelling story from the FOMC projections was the diffusion index of participant risk weighting to growth and inflation. For growth, the downside risks were the highest on record, and for inflation, the upside risk was similar to 2022 levels. The fundamental outlook for the US economy has deteriorated and we don't see any short-term fix to change the trend. At the same time, the "once-in-a-lifetime" fiscal policy adjustment from the outgoing German government is driving growth sentiment improving in the European economy before any money has actually been spent. The scale of the fiscal package is significant and we believe this will likely boost European growth for the decade to come. The Eurocoin indicator, which is the coincident growth indicator for Europe, is currently at highs last observed in 2022 when the impact of higher rates and energy prices started to slow the eurozone economy. We are in a recovery phase in Europe after the last two years of sub-trend growth.

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Creating Opportunities

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Profit margin convergence. Equity profit margins are not reflecting this economic reality, with profit margins in Europe having come under pressure recently, while profit margins in the US remain near record levels. Going forward, we would expect profit margins in the two regions to converge, which we believe is likely to be a critical driver of the continuation of the European exceptionalism trade. The fundamental convergence is also likely to drive investor flows into European financial assets, which should support cross-asset outperformance and should be the key driver of the European exceptionalism trade.

Risks remain. Tariff uncertainty is the biggest headwind for the European exceptionalism trade, although thus far US policy has shown that its bark is bigger than its bite. As a result, we would need to navigate the key 2 April deadline with caution. The tariff risk, while substantial, is unlikely to deter the growth capex cycle we are likely to see start in Europe with the German fiscal policy.

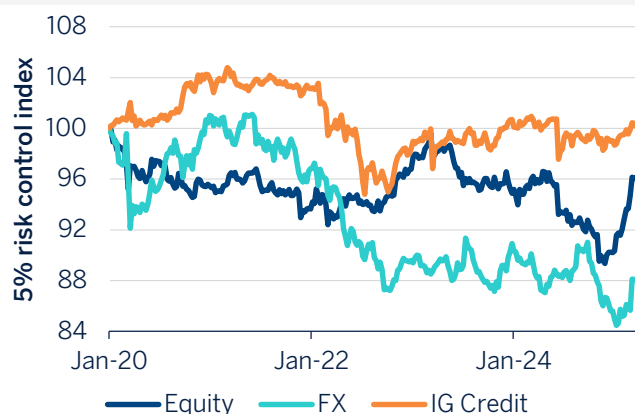
Upside catalyst: While tariffs remain a risk, the offsetting positive momentum from a possible resolution of the Russia/Ukraine conflict is substantial, in our view. Rebuilding infrastructure in Europe will require years of capex, which should be a boost for European corporates. In addition, European assets and economic growth have clearly been under pressure since 2022 on the back of the war and could see upside from a potential resolution.

Cross-asset European exceptionalism. Despite the outperformance of the Europe-first trade, we believe momentum remains strong in the European economy. Investors agreeing with our view could consider:

1. **Long SX5E / Short SPX:** The BBVA equity strategy team expects "Europe to outperform short-term if ceasefire (between Russia/Ukraine)" ([See note](#)).
2. **Long European IG credit vs. US:** The BBVA credit strategy team agrees with the idea of preferring EUR Credit vs. USD Credit at current levels and despite the YtD25 tightening we have seen in EUR Credit relative to US Credit spreads. Our thesis relies on supportive fiscal spending from Germany, expected rate cuts and a lower risk of recession in Europe vs. the US (c.30% vs 45% in the US, as per BBG estimates). Underlying fundamentals in European corporates and financials remain healthy, all-in yields are attractive vs. historical levels (c.3.3% now) and there are protective break-evens for both IG and HY. See notes [here](#) and [here](#).
3. **Long basket of EUR, GBP, SEK, NOK, CHF against USD:** The BBVA FX strategy team expects European FX to strengthen vs. the USD, with a particularly positive view on EURUSD, SEKUSD and NOKUSD. We are neutral CHF with domestically driven risks to the GBP ([See note](#)).

Figure 1

Cross-asset European exceptionalism has room to run



Source: Bloomberg and BBVA Global Markets Strategy

Figure 2

FOMC assessment of current growth deteriorating at the fastest pace



Source: Bloomberg and BBVA Global Markets Strategy



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Figure 3

FOMC assessment of current inflation upside risk near its highs



Source: Bloomberg and BBVA Global Markets Strategy

Figure 4

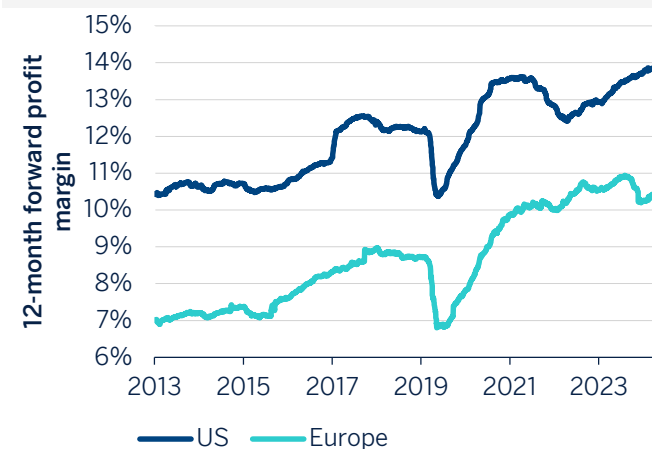
European growth expectations improving at the fastest pace since Covid reopening



Source: Bloomberg and BBVA Global Markets Strategy

Figure 5

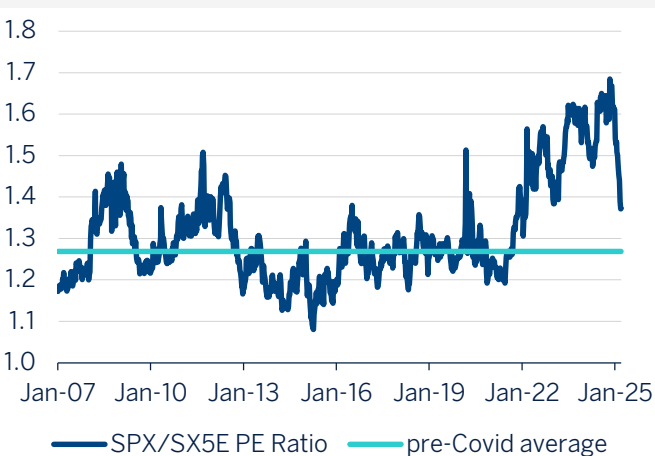
Equity profit margin not reflecting growth reality



Source: Bloomberg and BBVA Global Markets Strategy

Figure 6

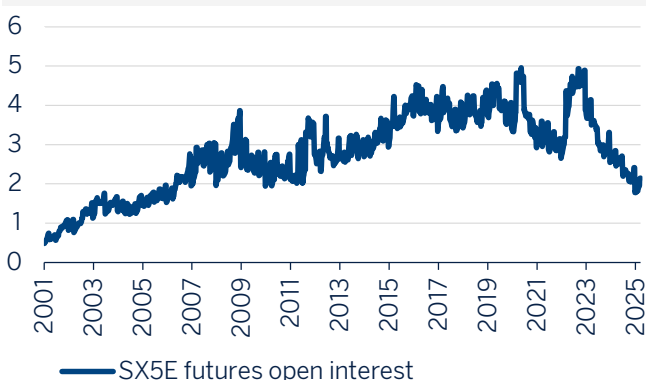
Valuation gap has room to recover



Source: Bloomberg and BBVA Global Markets Strategy

Figure 7

SX5E aggregate futures open interest remains near two-decade lows



Source: Bloomberg and BBVA Global Markets Strategy

Figure 8

USD still near 20-year highs



Source: Bloomberg and BBVA Global Markets Strategy



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