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Tariffs Secondary to Industrial Divergence

Europe should not lose sight of issues at home

- Tariff fears persist for Europe, but marginal impact is waning
- Under-positioning in industrial equities reflects valuation discounts
- Market not partial to industrial sector in general, but Europe is more underweight

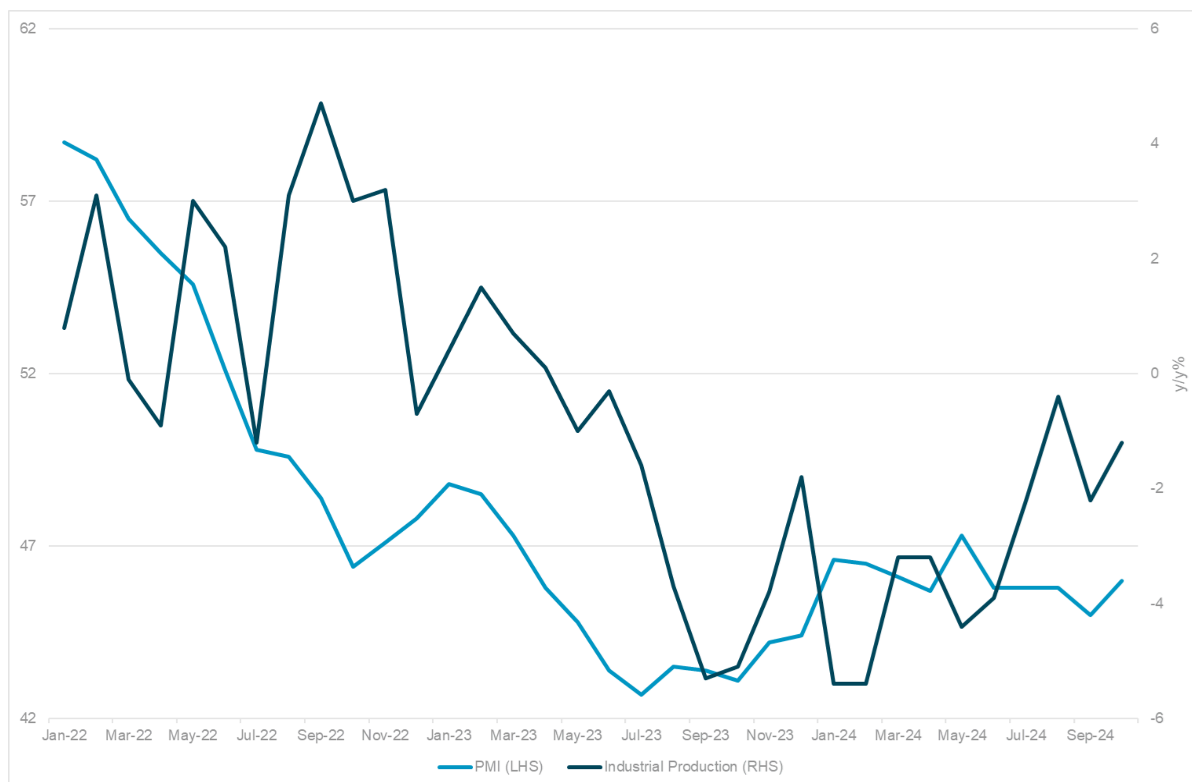
Valuation relief at European companies masks structural gaps vs. US

The incoming US administration's tariff policies continue to drive markets, and currencies struggled against the dollar yesterday amid talk that tariffs on critical imports will affect "every country." This remains a particular concern for Europe, whose industrial export base is being squeezed by weaker demand and growing competition from China on one end, and by the prospect of a serious curtailing of access to US markets on the other.

As highlighted in our "case for a euro base," we think issues are largely in the price, and price action on Monday supports the view that the marginal impact of even just the talk of tariffs is starting to erode. We cannot rule out a more serious escalation, but when it comes to European industry, we believe the issues are closer to home and need to be resolved. Despite our view that stabilisation is now taking place in the sector, it is only manifested in contraction not getting worse. This is the case in both hard (industrial production) and soft (manufacturing PMI) data (Exhibit #1), although there are also some early indicators of recovery in the former. Tariffs are an important matter for the political sphere, but Eurozone policymakers and industry will need to address a competitiveness deficit – highlighted by the Draghi report – which is not only hampering growth but also depressing local valuations and inhibiting greater investment flow. The upside surprises we anticipate in European equities

are viable based on earnings translation from the weak euro and positioning rebalancing alone. However, these are mean-reverting factors for asset allocation. For Europe and especially the eurozone to realise long-term allocations commensurate to the size of the economy, companies should look to the US as a benchmark and recognise the need for convergence in core factors affecting valuations.

Exhibit #1: Eurozone Manufacturing PMIs vs. Industrial Production



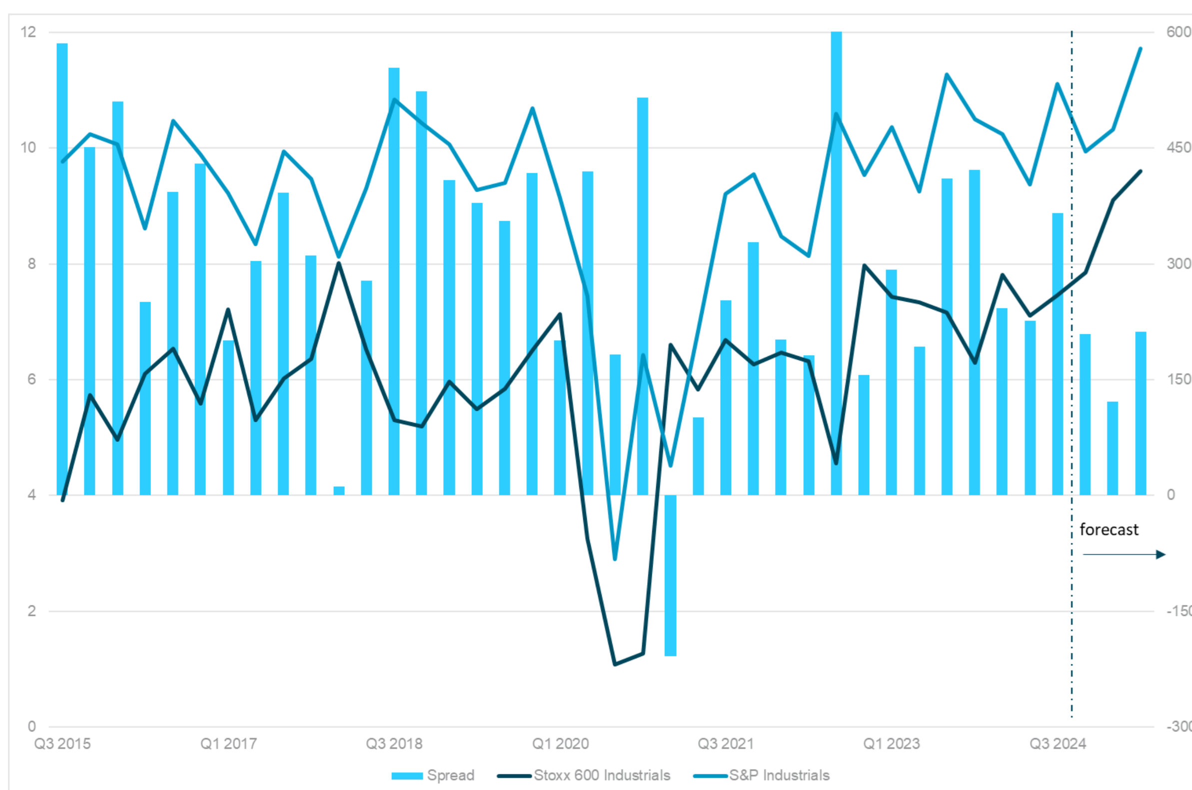
Source: Bloomberg, BNY

For example, margin hoarding has been cited as one of the key factors behind inflation in recent years. A 2024 ECB reported noted that “firms’ profit margins (before taxes) rose from an average of 4.3% of operating revenues in the period 2014-19 to around 5.8% in 2022. At the firm level, a similar increase was observed for average and median firms. For the average firm, profit margins rose from 3.8% in 2014-19 to 5.3% in 2022, while for the median firm they went from 2.8% in 2014-19 to 3.9% in 2022.” This needs to be viewed in a negative context for growth, as the ECB also noted that “higher profit margins are estimated to have improved the ability of firms to hoard labour in the event of an adverse shock to their economic outlook.” On the other hand, this also means that demand and inflation would not be falling as expected even with tighter financial conditions.

Isolating the Eurozone industrial sector's performance, the Stoxx 600 index’s profit margins are expected to rise by nearly 10% by Q2 2025, and we can clearly see that trend growth is

in place compared to pre-pandemic levels (Exhibit #2). However, asset allocation is a relative story as well and relative to S&P 500’s (GICS level 1) Industrials Index, the gap between Eurozone and US margins remains material, with an average gap of 150bp expected for this year. Admittedly, compared to pre-pandemic levels the Eurozone appears to have managed to close the gap to some extent, but data show that there has only been one quarter – Q2 2021 – when Eurozone margins were stronger than the US industrial counterpart, and that was hardly the best point of reference. As stated earlier, cost-cutting or relying on earnings translation for margin growth can only go far. The longer-term gains in real terms can only be achieved through productivity growth.

Exhibit #2: Eurozone vs. US Margins

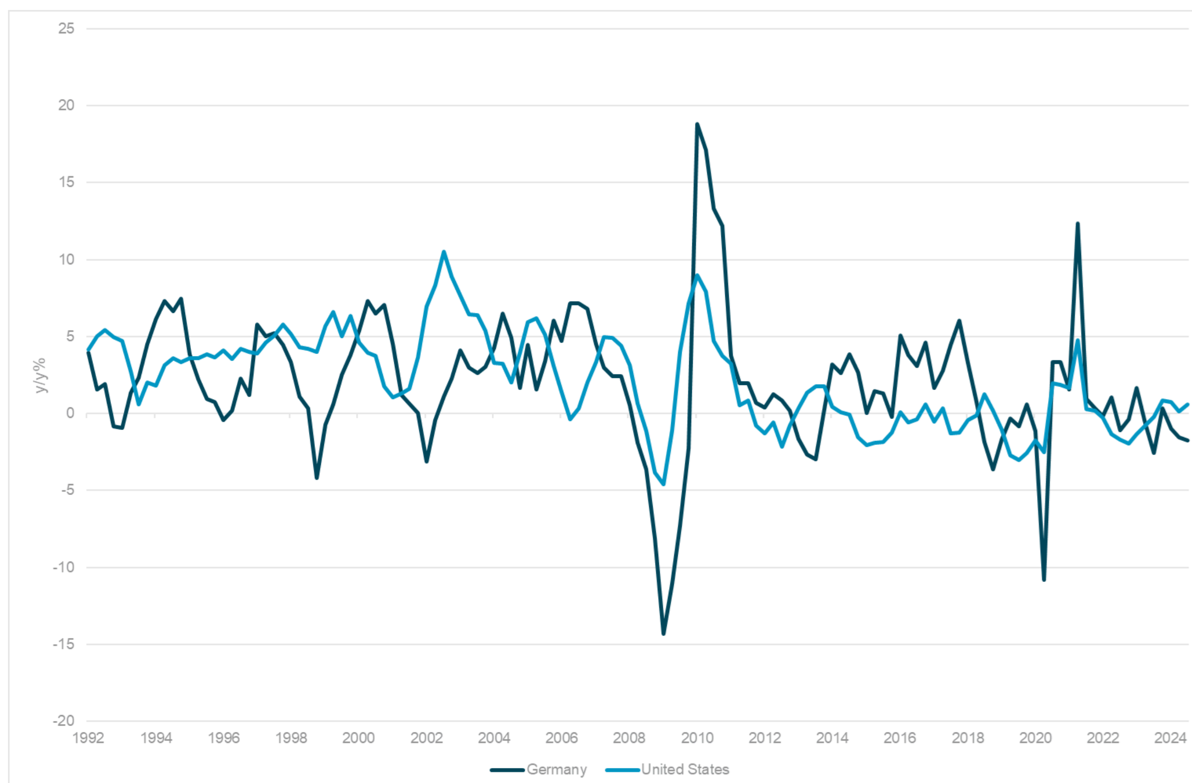


Source: Bloomberg, BNY

For consumer-driven economies such as the UK and the US, services productivity is often seen as the more important driver of growth. However, industrial policies over the past few years have shifted materially such that the European Union – with Eurozone industry at its core – now risks being left behind. Simply isolating productivity in industry (ex-construction), we can see that German productivity has now fallen below US equivalents since 2022, after having attained material advantages for much of this century. The conventional drivers, such as energy costs, innovation and regulation, still apply, and without serious change the compounding effect of productivity growth divergence will only widen the current valuation gaps. The last time the US held a material industrial productivity advantage over Germany

was during the early 2000s, and that was the last period of serious German reform, which resulted in strong growth productivity gains the following decade. Rather than tariffs, it is these shortcomings relative to the US which can and must be addressed internally.

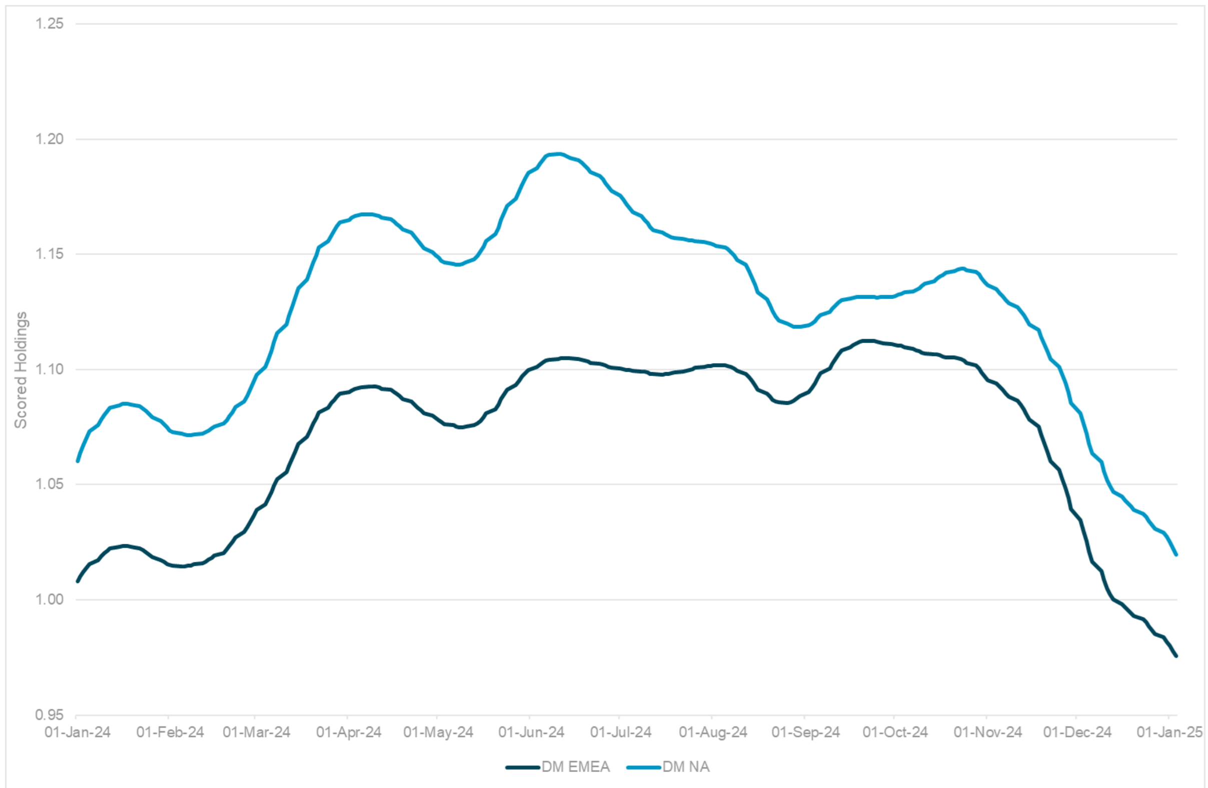
Exhibit #3: Germany vs. US Manufacturing Productivity



Source: Macrobond, BNY

In an asset allocation context, however, it seems that the industrial sector is out of favour globally at present. Our flow data reveal that following an increase in allocations in Q2 2024, there was a steep decline in industrial holdings in both Eurozone and US markets in Q4. The result of the US presidential election and a less dovish Fed both constrained elements unfavourable to positioning. That aside, on a relative basis industrial sector holdings in Europe were weaker than their North American/US equivalent all year. The gap narrowed in late Q3 and early Q4 as US growth prospects were de-rated individually, but since then both economies have struggled materially. By every measure, European industry is receiving a discount, but it is not extremely large and there is scope for convergence. The threat of tariffs should incentivise a new round of innovation and productivity gains as an offset. Either way, we expect allocations to European industrials to improve this year, but once the re-rating is decomposed, we hope the contribution from euro weakness will be as small as possible.

Exhibit #4: Equity Holdings – Industrials (GICS 1)



Source: BNY

Please direct questions or comments to: iflow@bny.com

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