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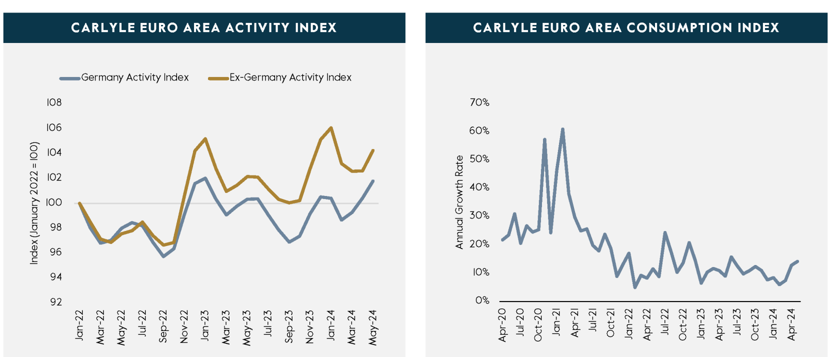
Growth in Europe may be unimpressive, but it's unambiguously positive (Figure 1). That hasn't been the case over much of the past two years. Good months had been followed by bad, contraction in some member states canceled out expansion elsewhere, and EU-wide economic growth seemed to oscillate around zero.

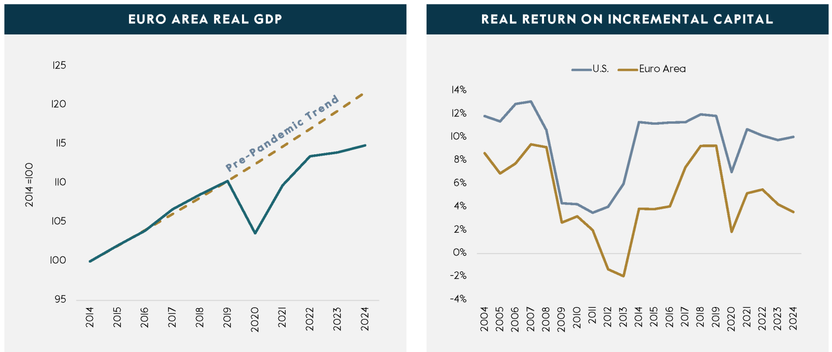
Figure 1: Better Recent Data in Europe



Source: Carlyle Analysis of Portfolio Company Data, May 2024. There can be no assurance these market conditions will continue to be achieved.

After two years of near stagnation, the euro area economy sits 5.5% below its pre-pandemic trend. Though unemployment remains near all-time lows, the implied productivity of capital has declined by about 200bps since Russia's invasion of Ukraine (Figure 2). And this comes in the context of a cost-of-living shock, a confluence of challenges not lost on the European electorate.

Figure 2: Difficult Post-Pandemic Environment



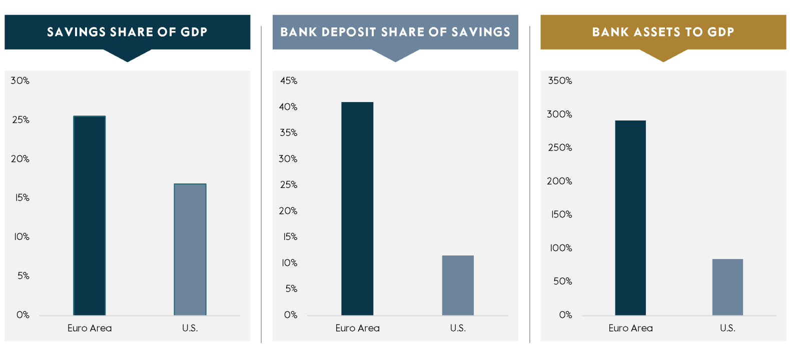
Source: Carlyle Analysis; IMF WEO Database, May 2024. There can be no assurance these market conditions will continue to be achieved.

European parliamentary elections conclude Sunday. Few seem to think they matter. Others are interested only to see the share of votes captured by reform and identitarian conservative parties seeking to capitalize on voters' discontent. But observers may be underestimating the potential scale of **positive** changes in store.

Last September, European Commission President von der Leyen deputized former ECB President Draghi to draft a "competitiveness" plan to guide EU policymaking over the next five-year mandate. Draghi's report is due later this month, but a recent speech revealed the radical change he intends to propose. This initiative received high-level political cover last week when the President of France and Chancellor of Germany issued a rare joint declaration pledging their full support.

The U.S. "Inflation Reduction Act" served as a wake-up call for the EU. "Competitiveness" was once short-hand for keeping (productivity-adjusted) wages low in a world of frictionless trade and capital mobility. Today, it references "industrial policy" that augments the domestic green and defense manufacturing base and facilitates consolidation to capitalize on the continental scale of the EU market and its 450 million consumers. But the means of the project are as important as its ends. The agenda will require hundreds of billions of euros of annual investment and most of that will have to come from private sources. The EU possesses the necessary resources – the EU saves more than the U.S., both in absolute terms and as a share of national income – but too large a share of that savings has been channeled to low-yielding bank deposits rather than capital markets (Figure 3).

Figure 3: More Savings, Less Participation in Capital Markets



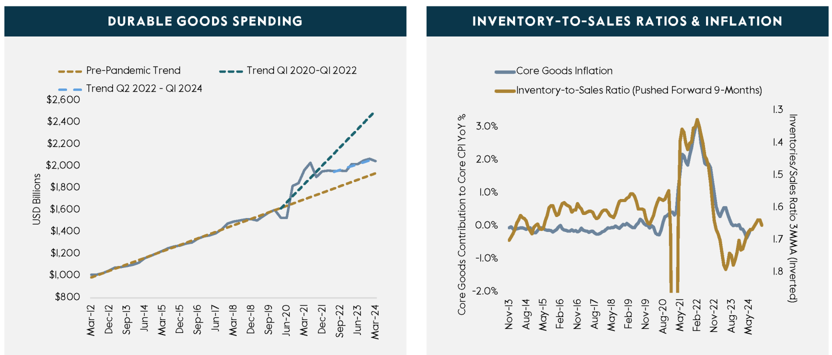
Source: Carlyle Analysis; EFAMA, January 2024. There can be no assurance these market conditions will continue to be achieved.

Policymakers recognize that it is only by solving the capital formation problem that Europe can hope to address all the others.

The Volatility of Price Volatility

For a time, it seemed that inflation would prove “transitory” because so much of it was explained by sudden shifts in consumption likely to reverse over time. Bereft of live entertainment options during the pandemic, consumers turned spending into its own form of entertainment. Boxes from online retailers piled up on doorsteps. Spending on hot tubs, motorcycles, and guitars surged at [never-before-seen rates](). Prices spiked as the inevitable shortages manifested (Figure 4).

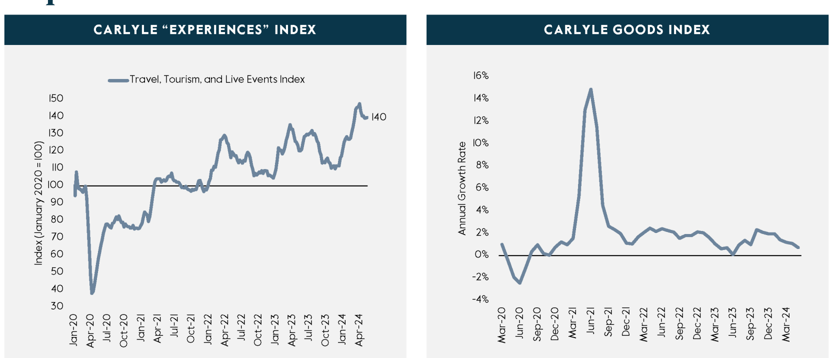
Figure 4: Trends in Durable Goods Sales & Inflation



Source: Carlyle Analysis; BEA, Federal Reserve, May 2024. There can be no assurance these market conditions will continue to be achieved.

Instead of reverting back to “normal,” spending swung sharply in the direction of “experiences,” which remains about 40% above pre-pandemic levels (Figure 5). This shift has endured partly because of the interest rate shock, which reduces the effective cost of current expenditures, like dining out, relative to durable goods, like autos, that generally need to be financed.

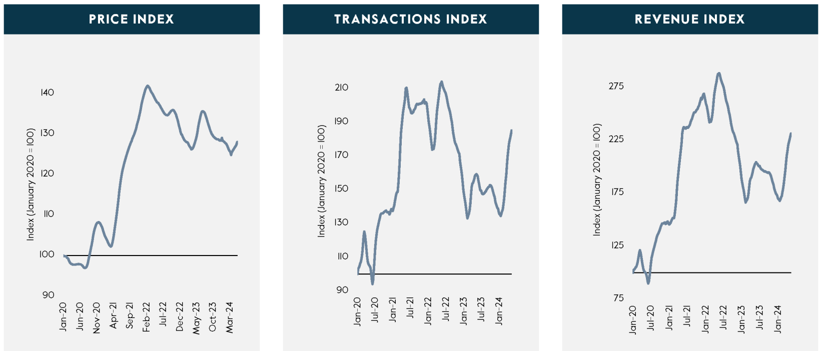
Figure 5: Consumers Shift from Goods to Experiences



Source: Carlyle Analysis of Portfolio Company Data, May 2024. There is no guarantee any trends will continue.

One lesson from all of this is that volatility begets volatility. Take the case of the used car market. During the pandemic, sales volumes doubled in less than a year, leading to a 40% increase in prices. Waning demand and higher rates then led to a 40% drop in volumes over the course of 2022, leading to aggressive discounting of overstocked inventories. But as the price discount relative to new cars widened – automakers have generally chosen to defend margins at the expense of unit sales – used car sales and prices rose once again (Figure 6).

Figure 6: Volatility in the Used Cars Market



Source: Carlyle Analysis of Portfolio Company Data, May 2024. There is no guarantee any trends will continue.

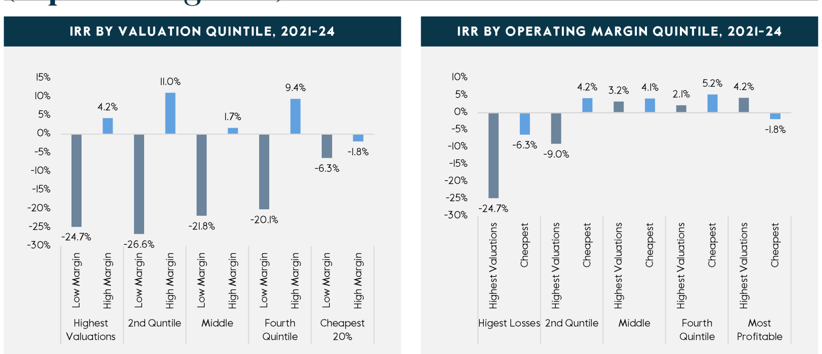
There is no magic to the Fed's 2% inflation target. But "price stability" seems unassailable as a goal. And it's easy to see why policymakers are not yet uncomfortable they've achieved it while witnessing unpredictable swings of this sort.

Cash (Generation) is King

The S&P 500 has returned about 7%, annualized, since the middle of 2021. But, as is well understood, much of that is explained by seven Megacap tech stocks, which now account for over 30% of the index (up from 18.5% at the end of 2019) and 13% of global market capitalization (up from 6%). On an equally weighted basis, the U.S. stock market has returned about 2% (annualized).

The impact of the interest rate shock has been more nuanced than many expected. Cheaper stocks (based on price-to-sales or price-to-book) have outperformed more expensive rivals by about 500bps, on average. But the big story has been profitability. The highest margin businesses have outperformed those with the lowest margins (i.e. loss-making growth) by nearly 25%, on average, and that outperformance holds across valuation quintiles (Figure 7). When restricting the analysis to the top 60% of stocks in terms of operating profitability, entry valuation does not clearly predict subsequent return. (The cheapest companies experienced declining sales, hence low returns).

Figure 7: U.S. Stock Market IRRs Since June 2021 (Equal Weighted)



Source: Carlyle Analysis of CRSP Data, May 2024. There is no guarantee any trends will continue.

The problem, it seems, was not "overpaying," per se, but "overpaying" for top-line growth without reference to underlying profitability.

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