ALLOCATION TRENDS

THE EUROPEAN TILT: A 2025 RENAISSANCE

JULY 2025

KEY TAKEAWAYS:

- European equities are gaining renewed interest due to policy-driven trends and shifting valuations.
- Fixed income opportunities are emerging from interest rate differentials and market conditions.
- Real estate is stabilising, with robust rental activity and limited new supply.
- Changing market correlations may enhance diversification opportunities.

At 2025's halfway mark, European equities have staged a notable comeback, outperforming the US markets. This marks a sharp reversal from more than a decade of US equity market dominance and raises a critical question for CIOs: Is this the start of a structural shift in global equity leadership?

The performance gap is largely driven by diverging macroeconomic trajectories. The US growth outlook has been downgraded due to aggressive import tariffs, while Europe is experiencing a rare fiscal renaissance, particularly in Germany. Earnings estimates project MSCI Europe to deliver double-digit annualised returns in US dollar terms over a typical business cycle, comfortably outpacing the Russell 1000 index. This differential is primarily valuation-driven: European equities remain attractively priced relative to the US, even after recent gains.

Europe's fiscal expansion, combined with structural reforms such as Mario Draghi's competitiveness agenda and the push for a unified capital markets union, could materially reduce the cost of capital and improve liquidity. As a result, the current environment offers a credible catalyst.

From a strategic asset allocation perspective, the breakdown in historical correlations between US and European equities, driven by divergent policy responses, sectoral compositions, and geopolitical developments, is particularly significant. The resulting lower cross-regional correlations, shaped by factors like US tech volatility and Europe's fiscal and energy shifts, enhance diversification benefits, likely improving risk-adjusted returns.

But the potential for outperformance is not limited to Europe alone, with global infrastructure investments and tail risk hedging strategies also offering opportunities to investors.

European earnings growth still faces headwinds, including US tariffs, Chinese competition, and domestic political fragmentation. Yet, the upside potential is substantial. For example, regulatory harmonisation in services alone could unlock billions of euros in efficiencies. Further gains could come from increased access to capital markets, reduced reliance on bank lending, and the creation of an EU safe asset to lower sovereign risk premiums.

For CIOs, the current environment presents a compelling opportunity to reassess geographic allocations. But where they might look?

PUBLIC CREDIT: LEVERAGING EUROPE'S RESILIENCE IN US TARIFF UNCERTAINTY

Against the backdrop of heightened tariff unpredictability in the US, Europe presents compelling investment opportunities, particularly in sectors demonstrating resilience and innovation. France's defence industry stands out due to its unique, vertically integrated structure, which minimises reliance on international supply chains. Historically considered a limitation, this self-reliant model could now prove advantageous. With steady government backing, French defence firms would likely benefit from guaranteed order books extending decades, providing unmatched investment security.

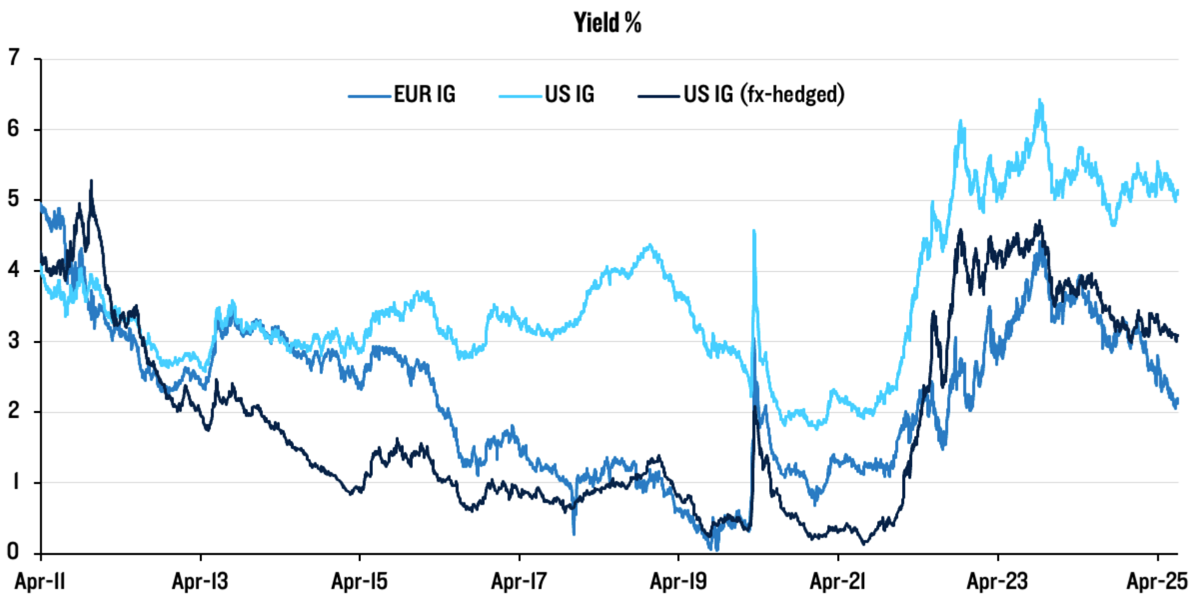
Similarly, Germany's defence sector, often underestimated, is gaining momentum on the back of recent government announcements to significantly increase defence spending. The country's manufacturing expertise, bolstered by its ability to redeploy resources swiftly, positions it to adapt and scale operations for defence production effectively.

Beyond defence, Europe's periphery markets offer fertile ground for growth. Greek banks are recovering with resilience, while Spain's booming professional services sector underscores the region's diversification. Greece's strides in renewable energy, particularly solar, signal significant prospects for investment, provided grid infrastructure is enhanced. These developments illustrate the growing dynamism within Europe's often underestimated markets, offering a counter to the perception of stagnation. Sectors tied to sustainable energy and financial revitalisation are poised to benefit from increased policy support and strategic funding.

Europe's potential for scalable innovation adds another layer to the investment appeal. Historically, promising enterprises like Skype and BioNTech pioneered in Europe but required external support to scale. A unified Capital Markets Union, now rebranded the Savings and Investment Union, could change this narrative, enabling startups to grow within the continent.

European bond yields have reached significantly more compelling levels compared to the past decade. The European Central Bank's faster pace of rate cuts relative to the US has widened the interest rate differential, making US dollar FX hedging more costly for European investors. As a result, European credit, particularly high yield, now offers a more attractive all-in yield profile, enhancing its relative appeal in global fixed income allocations.

Table 1: Gap in Hedged Yields Continues to Widen



Source: Bloomberg, Note: Hedged Yield = LUACYW + (EURI3M – US0003M)

PRIVATE CREDIT: RESILIENCE, DIVERSIFICATION, AND OPPORTUNITY IN EUROPE

Europe continues to stand out as a region of relative strength and resilience, particularly within the investment-grade credit space. Our European holdings, especially in large, diversified corporates, have demonstrated strong fundamentals and operational agility. These businesses often operate across multiple geographies, reducing their exposure to any single market or policy shift. Their ability to pass on cost pressures, including tariffs, reflects the strength of their value propositions and pricing power.

From a credit underwriting perspective, we remain confident in the quality of these issuers. Many have weathered a decade of macroeconomic shocks, from Brexit and COVID-19 to the Ukraine conflict and inflationary pressures, emerging more adept at managing supply chain disruptions and geopolitical uncertainty. This operational maturity is a key differentiator in today's volatile environment.

While smaller and mid-market companies, particularly those with concentrated export exposure (e.g., UK to US), may face more direct tariff-related risks, we've generally seen them adapt well. In sectors like consumer goods and the construction sector, there are some pockets of vulnerability, but these are more idiosyncratic than systemic. Even in these cases, the ability to pass on costs does not pose a major concern.

One area of caution is the muted transactions environment. Larger corporates are showing hesitancy to deploy capital amid global policy uncertainty and shifting trade dynamics. This caution is understandable: Why pursue cross-border acquisitions when the regulatory and geopolitical landscape remains so fluid? However, this also presents potential valuation opportunities for well-capitalised buyers with long-term horizons.

Broadly, there is a growing sense of optimism that conditions will improve. Discussions with advisors, sponsors, and companies all seem to imply that there should be an uptick in activity in the second half of this year. Investors have reason to be cautiously optimistic about on Europe.

From a macro view, Europe's fiscal stimulus and energy transition initiatives provide a distinct backdrop compared to the US While the US market is heavily influenced by AI-driven volatility, Europe offers a more balanced sectoral exposure. This divergence enhances diversification benefits and supports a more stable risk-adjusted return profile.

REAL ESTATE: PRIMED FOR PERFORMANCE

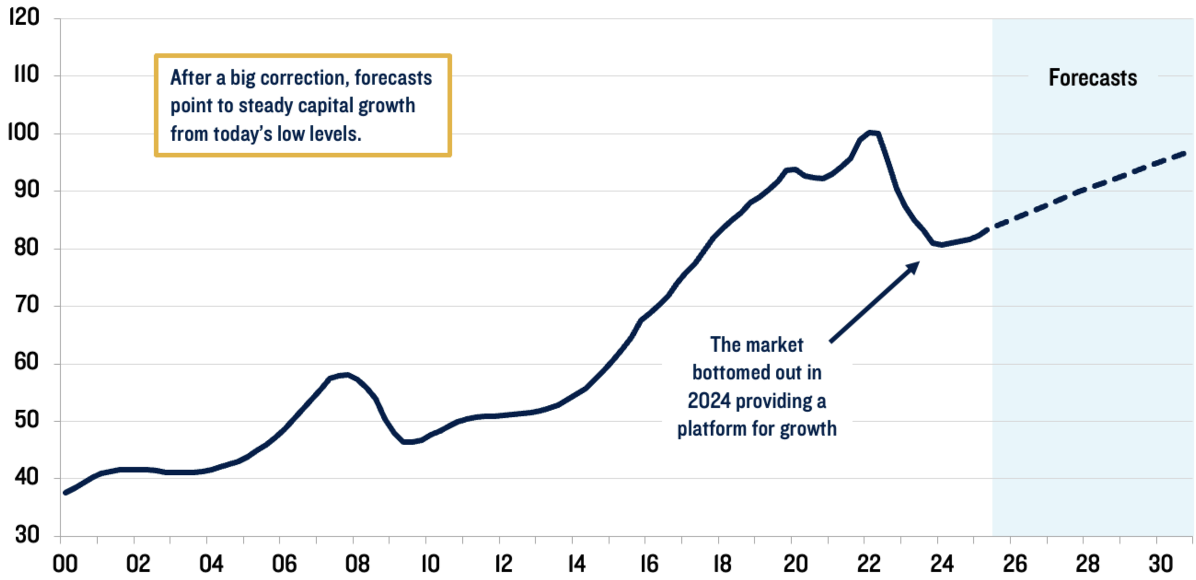
Despite ongoing global uncertainty and subdued economic growth, the European real estate market is showing signs of a durable recovery, offering compelling opportunities for long-term investors. Total returns are improving, underpinned by stabilising capital values, falling borrowing costs, and robust rental growth, particularly in sectors with constrained supply.

The sharp correction in asset values over the past cycle has already priced in much of the downside risk, creating a more resilient base for recovery. As interest rates begin to ease, faster in Europe than in the US, financing conditions are becoming more favourable, supporting both investor sentiment and transaction activity.

Looking ahead, the return profile is shifting from yield compression to income-driven growth. With historically low development pipelines and vacancy rates below long-term averages, rental growth is expected to remain strong, especially in sectors supported by basic needs and structural trends that support ongoing demand creation. These include assets in living sectors, such as apartments and multifamily in major cities, as well as co-living and student accommodation provisions. Urban logistics, with positive e-commerce dynamics, and datacentres are also seeing rising demand.

While macroeconomic and policy uncertainty may delay decision-making among occupiers and investors, the structural fundamentals remain intact. Low supply growth and fair valuations provide a cushion against volatility. For CIOs, this environment presents a window to selectively deploy capital into high-quality assets with strong income potential.

Table 2: Prime European All Property Nominal Capital Values (Index, 2Q22 = 100)



Sources: Cushman & Wakefield, PMA, PGIM Real Estate. As of June 2025.
Forecasts may not be achieved and are not a guarantee or reliable indicator of future results.

PUBLIC EQUITIES: NAVIGATING UNCERTAINTY THROUGH STRATEGIC INFRASTRUCTURE INVESTMENTS

Amid rising tariff tensions and global economic volatility, infrastructure investments offer a compelling case for institutional investors seeking stable, long-term returns. With inflation-linked revenues from certain assets like toll roads and utilities, infrastructure can provide a strong hedge against rising prices. Additionally, high barriers to entry in the sector preserve profitability by minimising competitive risks. These defensive traits position infrastructure as a reliable asset class, offering diversification away from more volatile equity markets while delivering consistent performance and also providing a better hedge against inflation than most bonds.

The appeal of listed infrastructure lies in its liquidity, potential income-generation capabilities and resilience to market cycles. Unlike private assets, listed infrastructure companies allow investors to enter and exit positions with ease, supporting scalable investments in a world where investors' liabilities can be uncertain or unpredictable. Consistent cash flows enable these companies to pay reliable dividends, making them a robust income source. Notably, listed infrastructure has demonstrated a low correlation to traditional equity markets, which enhances portfolio stability. Current valuations present a rare opportunity, with listed infrastructure equities trading below their historical average premium relative to global indices like MSCI ACWI, making this an opportune moment for allocation.

Listed infrastructure offers institutional investors a compelling blend of stable, inflation-linked income, immense liquidity and low correlation to traditional asset classes, making it a strategic allocation alongside assets like gold and index-linked bonds. With valuations below historical norms and private capital inflating prices in the unlisted space, listed infrastructure provides both liquidity and thematic exposure to long-term trends such as renewables and digital connectivity, positioning it as an attractive opportunity in today's high-rate, high-volatility environment.

QUANTITATIVE SOLUTIONS: HOW ARE CIOs FUTURE-PROOFING PORTFOLIOS WITH SMART HEDGING?

With rising market volatility due to tariff unpredictability and geopolitical tensions, investors are increasingly turning to nimble, risk-mitigating strategies such as overlays and option-based approaches to help manage downside risk and allow strong portfolio outcomes. The demand for such strategies has surged with clients from the Middle East, Europe, and Australia leading interest.

Changing market dynamics have disrupted conventional stock-bond correlations, necessitating innovative diversification strategies. Overlays incorporating tactical asset allocation and other high-return-on-capital models adapt portfolios to these shifts. A diversified mix of US, European, and emerging market equities, coupled with strategic real asset exposure can reduce vulnerabilities to single-sector shocks.

A significant evolution driving the demand for these strategies is the shift from traditional Strategic Asset Allocation (SAA) to Total Portfolio Allocation (TPA). This approach breaks down asset-class silos, aligning all components towards a cohesive, performance-driven goal. CIOs adopting TPA benefit from overlays, which compete effectively with private equities and fixed income due to their liquidity and adaptability. These strategies ensure capital flexibility across diverse economic backdrops.

If European equities outperform US counterparts, as projected this year, tactical tilts enhance allocations accordingly. Portfolios leveraging TPA frameworks are inherently flexible, improving risk-adjusted returns over time.

Unpredictable inflation and geopolitical triggers have underscored the importance of diversification. Commodities, often sidelined as "The Forgotten Asset Class," have delivered robust returns since 2020, particularly during inflationary or supply shocks. In the wake of geopolitical tensions such as the recent Iranian conflict, commodities rallied while equities and bonds faltered. Their role as inflation hedges or diversifiers ensures portfolios maintain smoother return profiles over volatile periods.

PGIM CONTRIBUTORS

Katharine Neiss, Chief European Economist, Fixed Income

Guillermo Felices, Global Investment Strategist, Fixed Income

Nicholas Samuels, Client Portfolio Manager, Global Equities

Florian Richter, Vice President, European Investment Research, Real Estate

Edward Jolly, Managing Director, Private Credit

Francesco Ascoli, Managing Director, Private Credit

Ed Barker, Managing Director, Private Credit

Marco Aoilfi, Managing Director, Quantitative Solutions
