

Mackenzie Europe Team

Time to revisit global diversification

The case for EAFE

In today's dynamic market landscape, the importance of international diversification cannot be overstated. The MSCI EAFE Investable Market Index (IMI), which serves as the benchmark for the Mackenzie International All Cap Fund, covers small, mid and large-cap companies across 21 developed markets outside North America. This broad exposure is particularly relevant in an era marked by deglobalization and capital fragmentation.

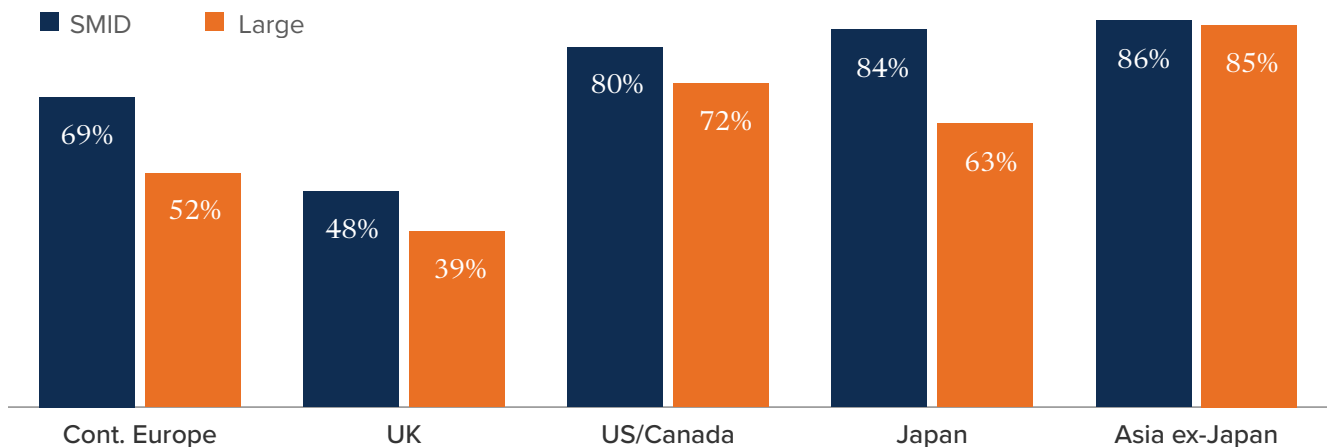
The concentration risk in US markets is becoming increasingly pronounced. The top 10 holdings in the S&P 500 now account for 36% of the index, compared to just 11% in the MSCI EAFE IMI. Furthermore, the US dominates 71% of the MSCI World Index, raising concerns about genuine global exposure. By incorporating EAFE equities into portfolios, investors can mitigate single-market and single-sector risks, achieving a more balanced and diversified investment strategy.

Why all-cap matters

An all-cap equity fund in EAFE markets makes strategic sense in today's evolving global landscape. As the world shifts toward regionalization and reduced globalization, many EAFE companies, particularly small and mid-cap names tend to be more domestically focused and less exposed to the volatility of global political and trade dynamics. This enhances their resilience in an increasingly fragmented geopolitical environment. By incorporating all capitalizations, such a fund can capture the breadth of opportunities, from globally competitive large caps, to nimble, locally anchored small and mid-sized firms poised to benefit from regional growth trends.

FIGURE 1 – Domestic revenue share

Small-to-mid cap (SMID) has greater domestic exposure and is less reliant on global trade



Source: JP Morgan



Europe's reinvestment shift

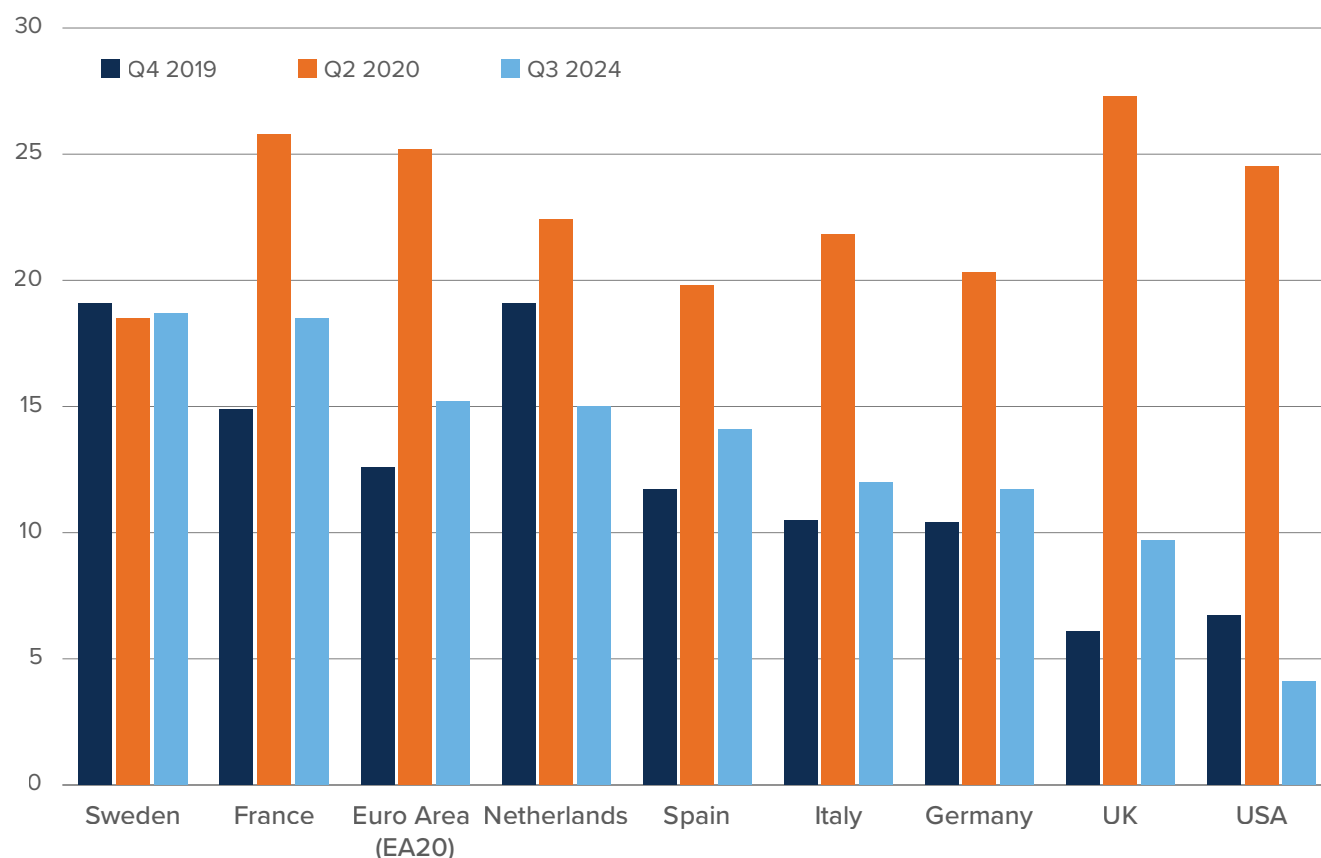
Europe is undergoing a structural shift. Moving past its austerity-era constraints, the region is embracing bold fiscal initiatives, like the EU's €750 billion NextGenerationEU plan targeting green and digital infrastructure. Germany, once a symbol of fiscal restraint, is now prioritizing growth via an infrastructure fund exceeding €500 billion.

Defence investment is also rising rapidly, catalyzed by geopolitical tensions. Europe is rebuilding its industrial and military backbone, with implications for aerospace, cybersecurity and high-value manufacturing.

Consumer and fiscal fundamentals improve

European consumers are on solid footing, with household savings at 15.3% — well above the US rate of 4.9%. This financial buffer enhances resilience and supports discretionary spending recovery.

FIGURE 2 – Household gross saving rate (%)



Source: Eurostat, Haver, Morgan Stanley Economics team Research forecasts



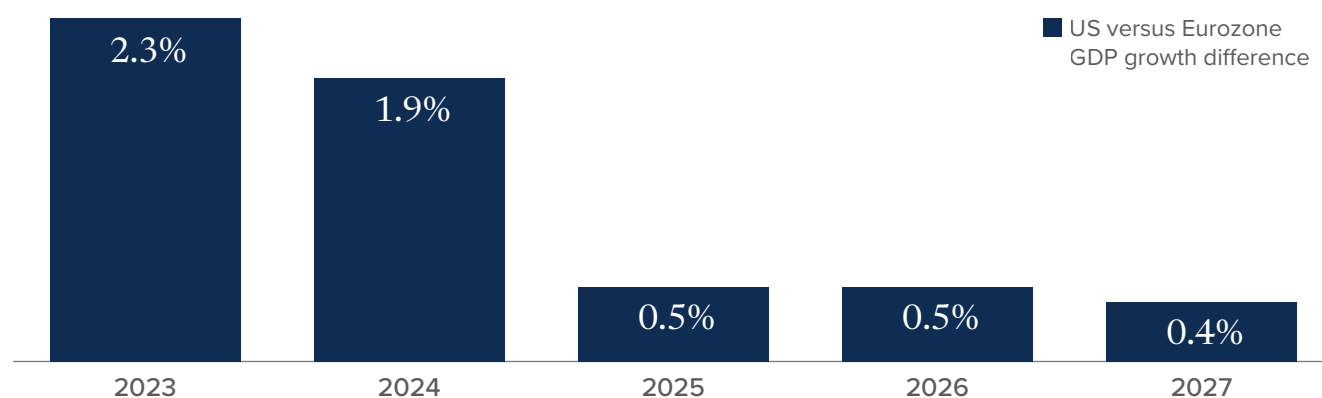
Narrowing economic growth gap

While the US has outpaced Europe in recent years — thanks to deeper capital markets, easier financing and a strong innovation focus — the growth gap is projected to shrink. The difference in GDP growth between the US and Europe, which was 2.5% in 2023, is expected to narrow to just 0.5% by 2027 as shown in figure 3. As the growth differential closes, the persistent valuation gap between US and European equities may also begin to compress.

Valuations: Europe “on sale”

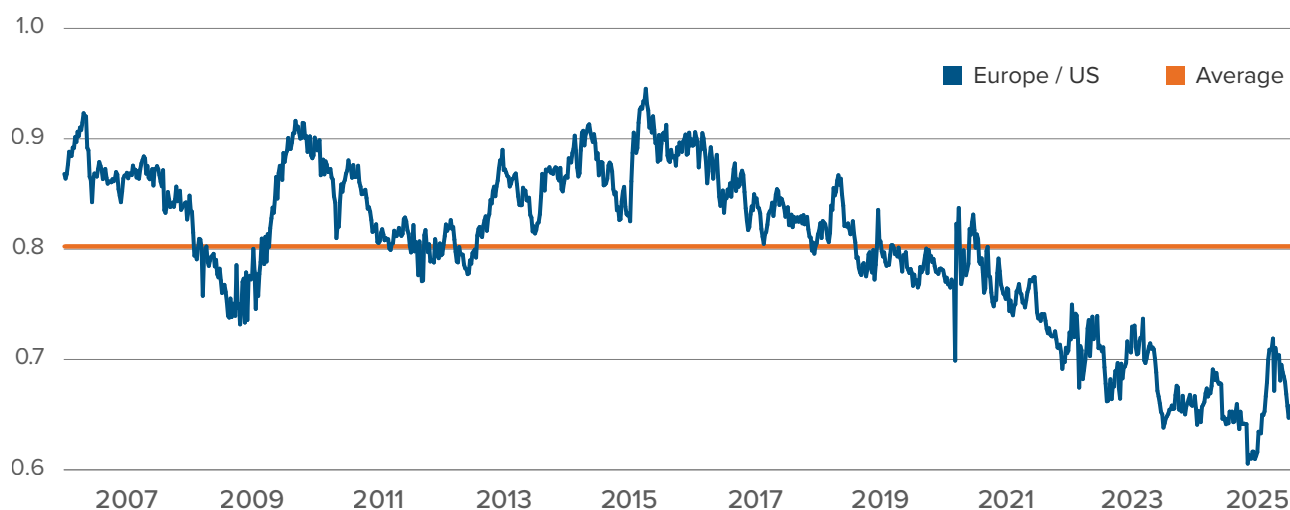
Despite improving fundamentals, European equities continue to trade at a deep discount to US peers. The MSCI Europe is priced at roughly 14× forward earnings, versus more than 22× for the MSCI USA. This wide valuation gap suggests that much of the pessimism about Europe is already priced in, setting the stage for outsized returns if the region modestly exceeds expectations.

FIGURE 3 – US/Europe GDP growth gap



Source: Bloomberg

FIGURE 4 – 12-mo forward P/E: MSCI Europe vs. MSCI USA



Source: Bloomberg

From periphery to pillar

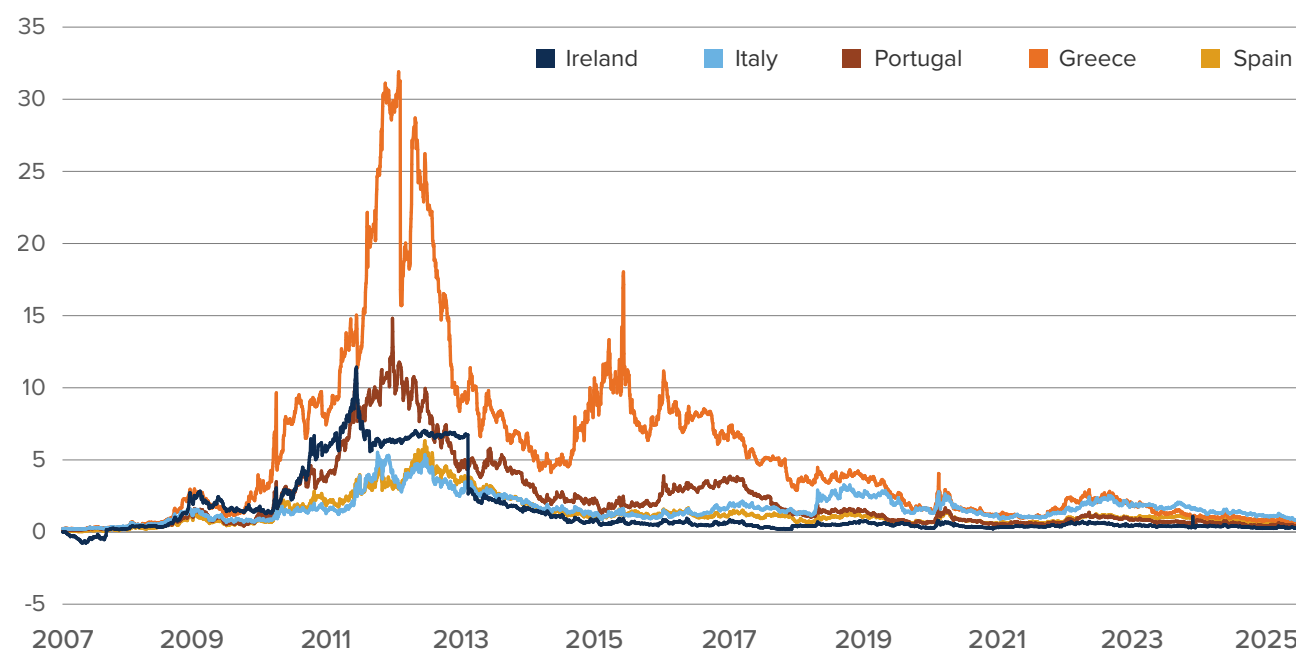
Europe's image problem, rooted in the legacy of the eurozone crisis, belies a broad-based improvement in fundamentals across the so-called peripheral economies. Countries such as Greece, Spain and Ireland have delivered structural reforms, reduced debt loads, and restored fiscal discipline, all while achieving growth rates that in many cases outpace their core European peers.

Greece, once synonymous with fiscal crisis, has recorded consistent primary budget surpluses and is forecast to reduce its debt-to-GDP ratio to around 158% in 2025, down sharply from its peak near 180%. Spain's debt trajectory is also improving, with the ratio now edging closer to 102% of GDP, supported by strong nominal growth and fiscal consolidation. Ireland, a standout performer, has seen its debt drop to approximately 76% of GDP, which is among the lowest in the EU, and is underpinned by consistent surpluses and one of the region's most dynamic labour markets.

Crucially, this fiscal improvement has been recognized by credit markets and ratings agencies alike. Sovereign credit upgrades and tighter bond spreads have followed, with Greece, Spain and Ireland now enjoying investment-grade ratings and borrowing costs near historic lows. Unemployment, once a source of social instability, has dropped to multi-decade lows in all three countries, further supporting domestic demand and reducing economic vulnerability.

These metrics signal that investor perceptions are lagging behind the economic reality. The macro risks that once defined the European periphery have materially faded. As market narratives catch up, the region is well positioned to attract renewed capital flows. What was once viewed as Europe's Achilles heel is increasingly becoming a source of strength and an underappreciated opportunity for global investors.

FIGURE 5 – Periphery 10-yr sovereign spread to German bonds (%)



Source: Bloomberg

European banks: from liability to leadership

Europe's banking sector has undergone a fundamental transformation. Post-financial-crisis reforms and conservative risk management have strengthened balance sheets, with capital ratios now more than double pre-2008 levels. Profitability has rebounded, with two consecutive years of double-digit ROE. The Euro Stoxx Banks Index is up more than 20% in early 2025, with valuations still modest at 8.4× 2026 earnings.

Banks are returning capital aggressively — with more than 25% of market cap through dividends and buybacks expected from 2024–2026. Industry consolidation and progress toward a banking union offer further upside.

European defence: An emerging structural theme

Europe's defence sector is undergoing a historic transformation, creating an emerging structural theme for investors. Long defined by underinvestment and reliance on US security guarantees, the region is now facing a new geopolitical reality that demands sustained and independent defence capabilities. The investment implications are significant.

The re-election of Donald Trump and recent statements from US officials have cast doubt on America's long-term security commitment to Europe. This has sharply heightened urgency among European leaders. At the 2025 Munich Security Conference, speeches by senior Trump allies were viewed as a turning point, catalysing a regional reassessment of military readiness. Meanwhile, NATO Secretary General Mark Rutte has warned of a potential conflict within the next five years, underscoring Europe's need to act.

Catch-up after decades of underinvestment

Historically shielded by NATO's Article 5 and a benign security environment, Europe consistently underfunded defence. Now, it must close a significant gap. European NATO members' defence spending reached

€440 billion in 2024 (2% of GDP), compared to 3.4% for the US. At the key June 2025 NATO summit, a target of 5% by 2035 was agreed by the allies, consisting of 3.5% hard military expenditure and 1.5% infrastructure.

Fiscal realignment in Germany and the EU

Germany's shift has been the most pronounced. With strong fiscal headroom (debt/GDP at 63%), the new CDU/CSU-led government announced a sweeping €500 billion off-budget infrastructure fund to be spent over 10 years. Additionally, new defence spending above 1% of GDP was declared exempt from Germany's constitutional debt limit, so it is effectively unlimited. Rheinmetall's potential acquisition of a Volkswagen factory for defence production highlights the industrial pivot underway.

The financing of this was covered in a June draft federal budget bill, expected to be passed in September, which plans for net borrowing of €850 billion over 5 years including €450 billion for defence and €270 billion for infrastructure. This €850 billion is a significant 19% of Germany's nominal GDP, cumulatively.

At the EU level, the European Commission's "ReArm Europe" initiative proposes mobilizing €800 billion via €150 billion in joint loans and €650 billion in national borrowing leeway designed to support joint procurement and sovereign borrowing flexibility.

Shift toward European-made equipment

In light of geopolitical risks and shifting transatlantic ties, European policymakers now favour sourcing defence equipment from within the continent. The EU has set a goal to meet at least 50% of procurement needs with European-made solutions by 2030, which would reverse a five-year trend of 65% reliance on US imports.

Europe's evolving defence posture marks a strategic inflection point. The combination of political will, fiscal flexibility, industrial coordination and shifting investor norms creates a multi-year runway for growth in the region's defence sector. For the first time in decades, European defence is not only a policy priority, it is a compelling, structural investment opportunity.



Conclusion: Europe's renaissance and the case for global equity allocation

Europe's story has evolved. What was once viewed as a value trap or diversification filler is now a dynamic investment case, underpinned by strong policy support, narrowing growth and valuation gaps, improving fiscal health and reformed industries.

For investors, international diversification — particularly through an all-cap EAFE strategy with Europe at the core — offers not only balance but the potential for compelling returns. In a shifting global landscape, international equities are not just in the background — they are stepping into the spotlight.

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