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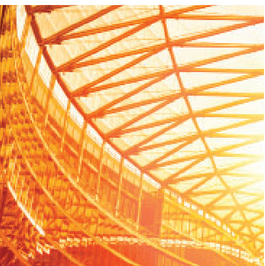
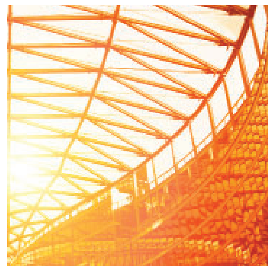
Research Note
June 2014

Slowly But Surely: Investors Should Stay the Course on European Equities

We maintain our advice to overweight European equities and underweight European bonds

- Macro data in Europe are slowly improving, but growth outside the Eurozone has been much stronger; corporate profits have also been lackluster but growth and/or cheaper currencies would help.
- European equity valuations are reasonable and reflect these weaknesses; they are attractive relative to overvalued US equivalents.
- Euro-denominated sovereigns and credits are priced to generate very low returns, especially if fears over deflation prove overblown. Gilts and sterling credits are also pricey, but higher yields give some scope for subsequent performance.
- Continued stagnation in earnings would cause us to reassess our equity call, while sharply rising yields would make us take a second look at both sovereigns and credits.
- Non-local investors in European equities and bonds should hedge currency exposure; if foreign portfolio flows have pushed up currencies and local assets there will be a "double-whammy" if these flows reverse while assets are selling off.

European assets have recently posted attractive returns as concerns over the debt crisis fade and as economic data improve across both Eurozone and non-Eurozone countries. Pan-European equities have returned over 50% since their June 2012 lows, while peripheral sovereign bonds and high yield have also been standout performers. For equities, this performance comes after an extended period of underperformance, which means that valuations have risen but remain attractive. Conversely, the recent rally has left many bonds with rich valuations, as

investors seem to be ignoring intermediate-term risks in the hunt for near-term gains.

In this research note we provide an update on the macro backdrop in Europe, revisit our advice on European equities and bonds, and explore what might be in store for currency markets. Recent market action hasn't caused us to change any of our existing advice across assets, though investors' growing complacency about credit quality and perhaps excessive pessimism over deflation makes us even more apprehensive about sovereign bonds.

Macro Backdrop

The Eurozone's economic recovery is slowly gathering steam after a prolonged slump. GDP is expected to grow by 1.1% in 2014 after two years of economic contraction. Certain metrics look healthier—the composite purchasing manufacturers' index (PMI) hit 53 this April, the highest level in three years. However, the debt crisis has left deep scars. Economic output remains below pre-crisis levels and unemployment has hovered near a cyclical high of 12% for most of the past 18 months, with Greece and Spain at levels more than twice as high. Since the start of the financial crisis the Eurozone has lost around five million jobs; in comparison, US employment (measured by nonfarm payrolls) is now above 2007 levels.

Many Eurozone countries continue to struggle with elevated debt levels and the fallout from the painful internal adjustments required to bring these liabilities under control. Without the ability to devalue their currency to boost competitiveness, many companies have cut labor forces and wages. Elevated joblessness is also the effect of efforts to narrow government budget deficits, as the government is a significant employer in many European economies. Structural reform such as labor market deregulation is ongoing, but will take time to translate into a relative advantage. Meanwhile, deficits continue to grow faster than economies in most countries, and debt burdens continue to mount (Figure 1).

The better news is that headline numbers about the Eurozone economy mask significant divergences across countries (e.g., Italian growth will likely be only slightly above zero in 2014 but Germany is expected to grow by nearly 2%) and tend to overshadow better conditions outside the common currency block. The United Kingdom's 1.8% GDP growth last year was among the best in the G7 and is expected to accelerate in 2014; data from other non–European Monetary Union (EMU) countries like Switzerland have also been more robust.

In addition, tensions within the Eurozone continue to ease and the threat of a member state leaving seems to have fallen, at least for the near term. Current account deficits have been slashed in the periphery largely due to falling imports, improving the balance of payments and reducing the need to borrow abroad. Core countries like France and the Netherlands have also become more sympathetic to providing debt relief for profligate spenders as they too struggle to grow. Some countries have reduced budget

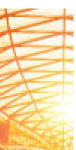
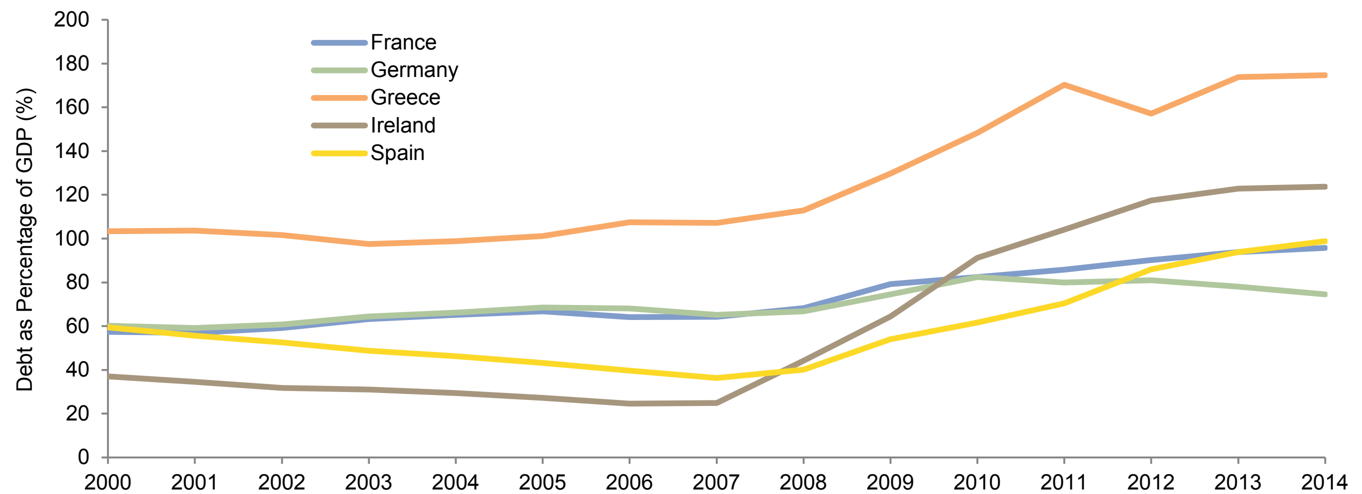


Figure 1. Eurozone Central Government Debt
2000–14



deficits and weaned themselves from troika funding; earlier this year Ireland and Portugal both formally announced their exits and tapped public bond markets.

While some dangers have receded, falling employment and income levels have increased the threat of deflation in the Eurozone. Eurozone consumer price inflation has fallen for around three years and hit just 0.5% in May, fuelling concerns about a "Japanification" scenario. Deflation increases the real value of debt, which makes servicing it more difficult. Deflation can also set off a vicious cycle where consumers delay consumption in the hope that prices will decline further, curbing growth. In contrast, UK inflation is much closer to the Bank of England's target at 1.8%, though it too has fallen given the strength of the pound and the reduced cost of imports like energy.

Stay the Course on European Equities

Last fall we advised overweighting European (both Eurozone and non-EMU) equities relative to US equivalents.[1] Our rationale included attractive absolute and relative valuations, as well as the potential for earnings to increase from a low base given the gradually improving macro backdrop just described.

Revisiting this call today, we see little reason to change course. European equities have started to outperform in recent months (Figure 2), but remain reasonably priced on both an absolute and relative basis. UK stocks currently trade at 13.3 times normalized earnings (virtually unchanged since last September); Europe ex UK stocks have rerated higher but remain in

[1] Please see our October 2013 Market Commentary *European Equities: Time to Focus on the Micro.*

Figure 2. Relative Performance of MSCI Europe and MSCI World
January 31, 2003 – May 31, 2014

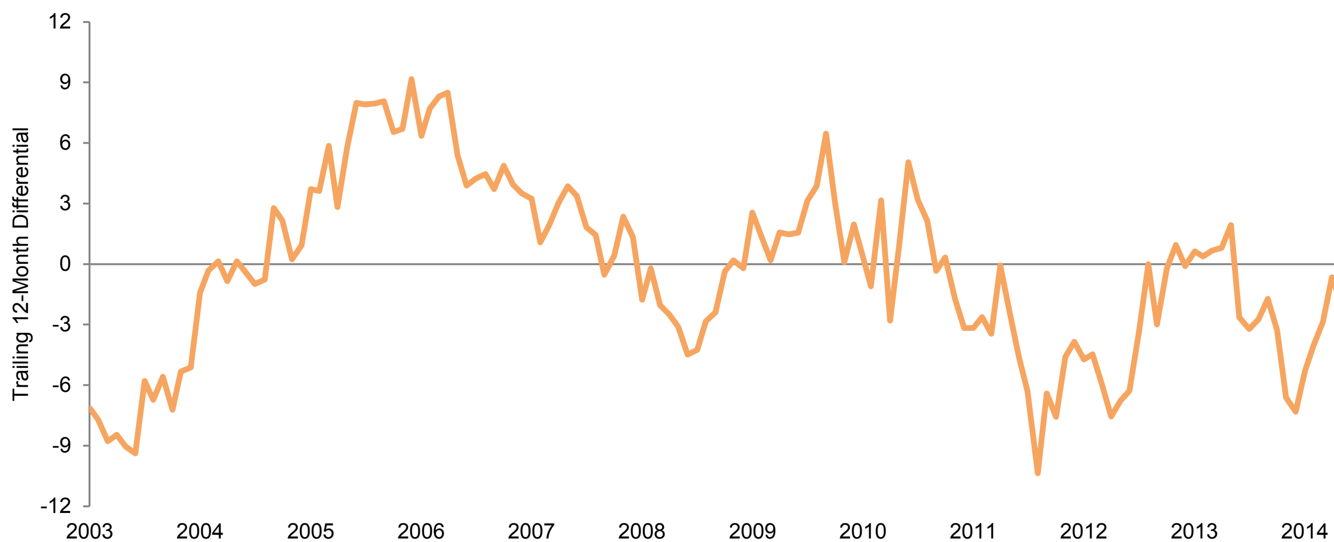
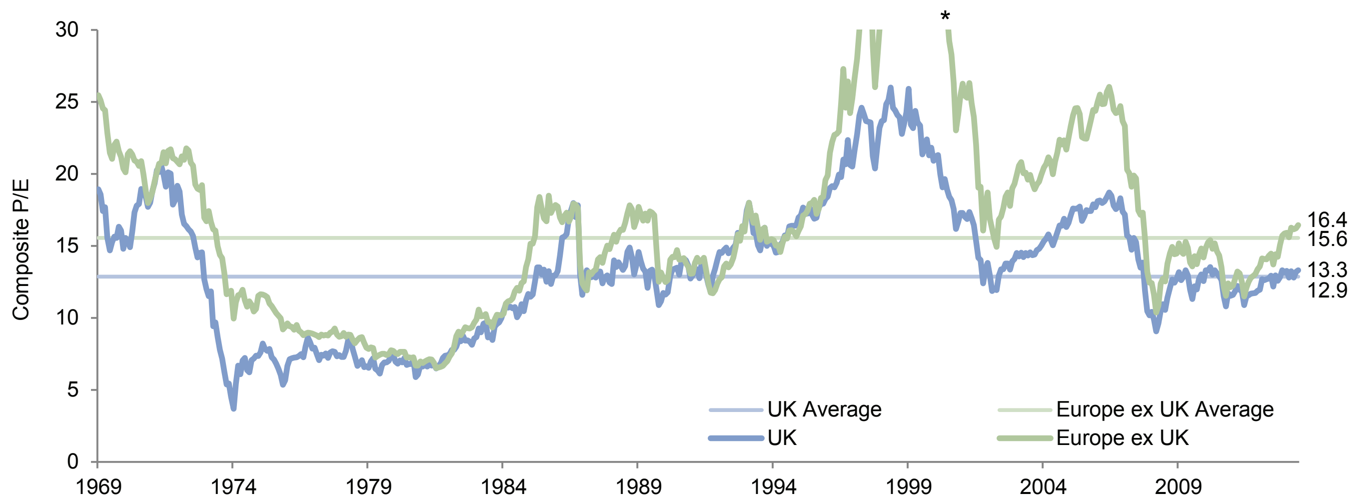
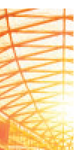
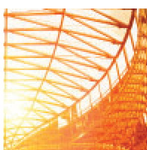


Figure 3. Composite Normalized P/E Ratios
December 31, 1969 – May 31, 2014



* Graph capped for scale purposes.

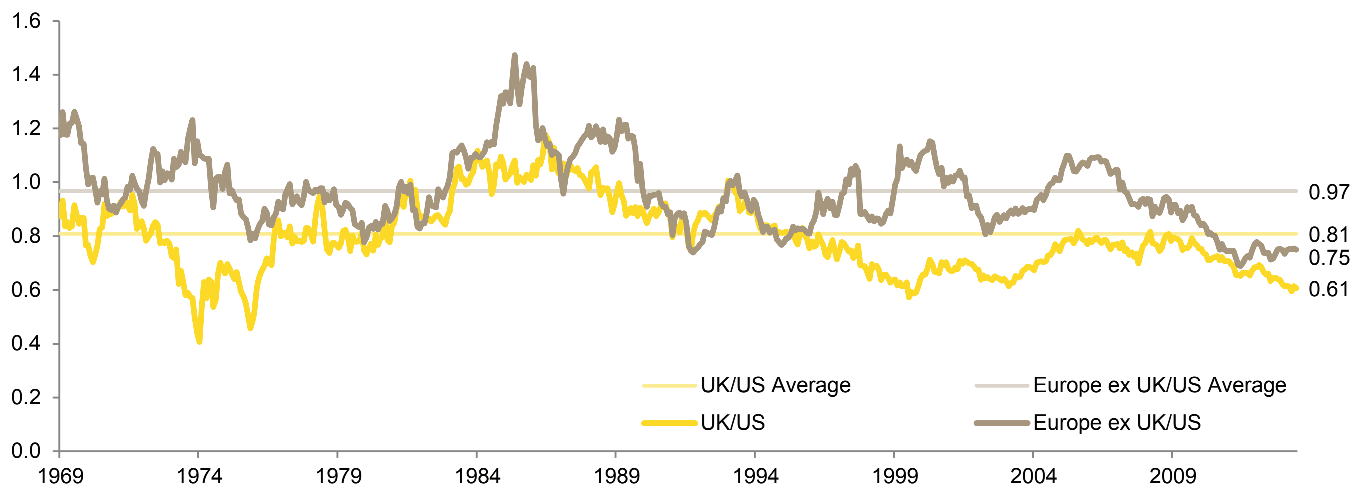



line with historical averages (Figure 3). On a relative basis, their discount to US equivalents is basically unchanged since last fall, with Europe ex UK and UK stocks trading at just 75% and 61%, respectively, of comparable US valuations (Figure 4).

Recent European earnings announcements have disappointed, though not to such an extent that valuations have moved meaningfully or that we see the need to change tack. European earnings fell 5% in 2013, comparing poorly to the United States, where profits grew 7%. Given flat profit growth during the first quarter, 2014 estimates have come down slightly since the start of the year and are now at 7%. The recession has left many levels of activity at severely depressed levels (cap ex is near historical lows, for example), but as they rebound so too should operating leverage and margins. First quarter earnings releases tended to blame currency strength and slower-than-expected growth in emerging markets as opposed to soft domestic demand. If these headwinds can dissipate for the remainder of 2014, profits should tick up.

As for peripheral equities, we would not advise tactical overweights to countries like Spain and Italy. While normalized metrics for these countries do look somewhat attractive relative to pan-European averages, past profit levels (especially for financials) are unlikely to be quickly revisited. Macro strength may be overstated and shorter-term valuation metrics look much less compelling on a relative basis. To give one example, Spanish stocks trade at 15 times forward earnings, more expensive than those in the rest of the EMU or the United Kingdom.

Figure 4. Relative Composite P/E Ratios
December 31, 1969 – May 31, 2014



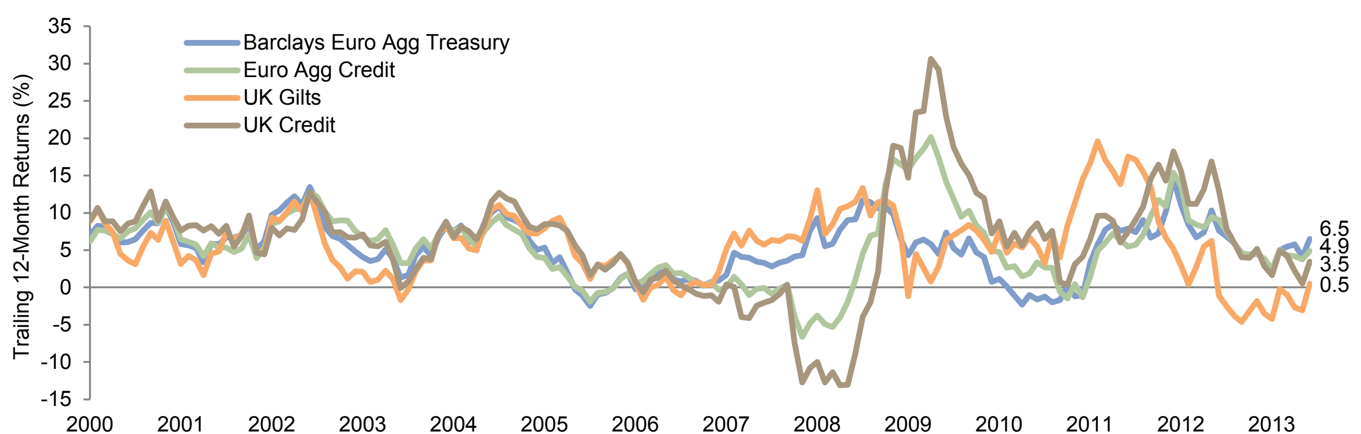
Bonds Are Even Less Attractive

Eurozone sovereign bonds have generated surprisingly high returns in recent years given slower growth and waning inflationary pressures. However, much of this has been driven by the rally in peripheral sovereigns, as gains on German bunds and other "core" sovereigns have been more muted. For example, though the trailing 12-month return on Eurozone sovereign bonds is 6.5% (Figure 5), the return on German bunds has been just 2.6%. Looking forward, historically low yields will cap subsequent returns; yields on German and Spanish sovereign bond indexes are just 0.85% and 1.86%, respectively. Signs of excessive enthusiasm seem apparent in some of the highest-beta sovereign markets; for example, Greece attracted over €20 billion in orders for a new bond deal in April despite sovereign debt that remains at nearly 180% of GDP and rumors about future restructurings.

Falling sovereign yields have created a tailwind for Eurozone credits. Euro-denominated corporate bonds have returned 4.9% over the past 12 months as the yield has declined to 1.54%. Technicals have been supportive: European bank deleveraging means net new issuance has been negative for each of the past four years. Credit quality seems more mixed; while European non-financial firms have deleveraged in recent years and cash balances are at record highs, European banks have struggled with profitability. Ernst & Young estimates that Eurozone bad debts increased by 10% last year to over €900 billion.[2] European high-yield bonds[3] have also had a strong run, returning 16% over the past year as yields plunged to a historical low of just 4.06%.

[2] "Flocking to Europe: Ernst & Young 2013 Non-Performing Loan Report," Ernst & Young, April 2013.
[3] Based on the Credit Suisse Western European High Yield Index.

Figure 5. European Bond Returns
December 31, 2000 – May 31, 2014



The story has been different across the Channel, where UK gilts have struggled given stronger growth and inflationary pressures. Gilts have returned 4.0% year-to-date, but are barely in the black over the past 12 months. Despite similarly positive supply/demand dynamics and falling spreads, rising gilt yields mean the trailing 12-month return on sterling-denominated credit returns has also been lackluster, though the 3.67% yield leaves more scope for subsequent performance.

A rally that has pushed many yields to historical lows presents an asymmetric risk/reward to investors and losses could occur under a variety of circumstances. Euro-denominated sovereigns and credit are priced to generate very low returns from this point, and leave little cushion for shifts in consensus thinking about future inflation, growth, or credit prospects. Peripheral sovereigns are vulnerable under a variety of circumstances. Debt levels remain excessive and slow growth and/or low inflation could challenge debt sustainability in several countries for years to come. Investors may also be overestimating the willingness and/or legal ability of the European Central Bank (ECB) to expand bond purchases if volatility resumes, though we concede ECB President Mario Draghi seems poised to do more and key constituents like the influential German Bundesbank seem to be dropping their resistance. Putting aside the signaling impact on confidence, Greece borrowing at higher rates in the public market than what the troika has offered actually makes its debt dynamics *worse* as opposed to better.

Currencies Present a Conundrum

The euro has risen steadily against the US dollar and other currencies (Figure 6) for most of the past year, wrong-footing many speculative investors. A variety of forces are likely in play. Eurozone export growth has been stagnant, but lower imports have improved the net trade position, creating demand for euros. Capital inflows have also been strong, as local fixed income and equity markets offered generous returns. At the same time, Eurozone banks are selling foreign assets (and then swapping the proceeds for commensurate euro amounts) as they deleverage. Disinflation has boosted the euro's real value. Finally, growth in other regions has also disappointed, and interest rates in countries like the United States have again come down after last summer's taper-related sell-off, reducing their relative attractiveness.

The euro's strength has negatively impacted European exports and corporate profits, though the economic slowdown in emerging markets has also played a role. The euro's strength against the US dollar has not been the only problem; the success of Abenomics in weakening the yen has also given Japanese industrial and auto companies a key competitive advantage.

On June 5, the ECB announced a series of measures intended to stave off the deflation threat and weaken the currency. These included cutting key interest rates and offering further long-term asset financing to European banks, as well as the suggestion that it was preparing

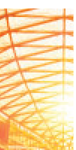
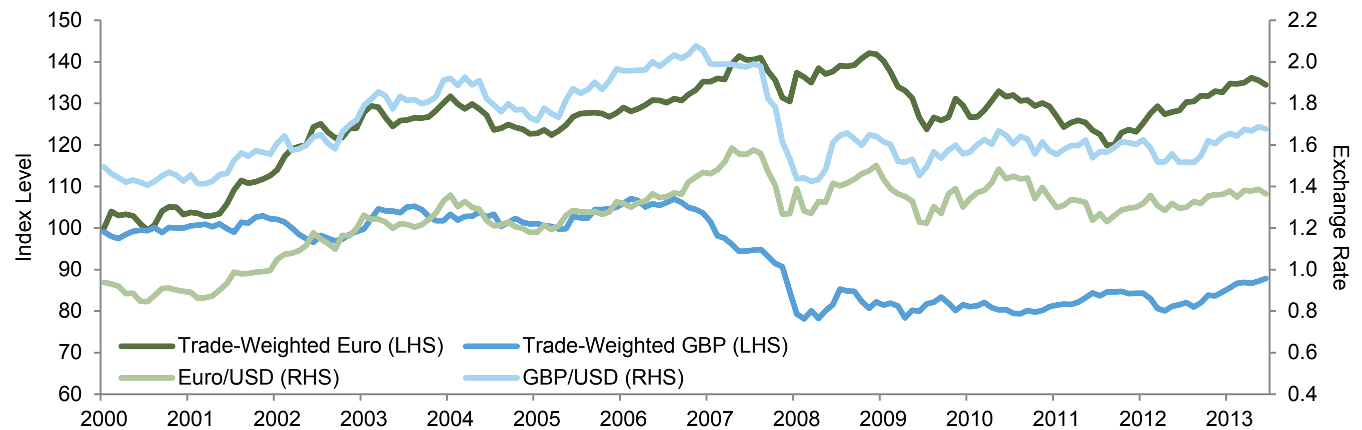


Figure 6. Currency Valuations
December 31, 2000 – May 31, 2014



to buy asset-backed securities at some point in the near future. Illustrating Draghi's conundrum, while the euro had sold off in prior weeks in anticipation of some type of dramatic action, it actually *rebounded* after the new policies were announced, perhaps due to further inflows of foreign capital.

While the immediate impact of these announcements was to push bond yields lower and equity prices higher, analyst opinions about the longer-term impact on economic activity were decidedly mixed. Interest rates are already effectively at zero in the Eurozone and cutting them further may do little to affect relative real rates or encourage lending. Local banks are trying to deleverage and repay funds to the ECB while credit demand has been limited, potentially curbing the impact of negative rates. Lower yields could dissuade further inflows from foreign investors, though this might occur in any event as bond returns start to fade. Finally, stronger import demand would help narrow the trade deficit, but this is not a foregone conclusion given the weak economic recovery.

The pound faces a different set of issues. Stronger growth in the United Kingdom reduces the need for the Bank of England to try to talk down the currency. Higher real yields and less political uncertainty are also supportive when compared to the euro. This said, the Scottish independence vote this fall represents an unquantifiable political threat, and the United Kingdom runs a sizable current account deficit, unlike the Eurozone. Two things may have recently supported the pound: the weakness of emerging markets currencies (on a trade-weighted basis) as well as higher projected interest rates relative to currencies like the US dollar. If either or both of these fade in the months ahead, so too could the currency's recent strength.

Possible Game Changers

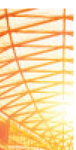
Our positive view of European equities is supported by valuations but also a presumed recovery in earnings power for European companies. Should earnings growth continue to stagnate or even drift lower, potentially because of a sharper-than-expected slowdown in emerging markets, we would reassess our position. Macro variables such as growth and employment have a limited influence on our equity call. This said, should recent positive momentum reverse in areas like labor market reforms and improving regional imbalances again deteriorate, we would also reconsider our position. We are also closely watching political events in Europe, as recent European Parliamentary elections indicate that support for the European Union is fading, perhaps because the slow economic recovery has tried voters' patience.

A deteriorating macro situation would also cause us to reassess our call on sovereign bonds, though we already consider these assets overvalued and advise underweighting them versus cash. While acknowledging that a sudden spike in interest rates seems unlikely, if a political or other crisis caused this to occur and the ECB was delayed in responding, we might sharpen our pencils, but would only become more constructive if we believed fundamentals had not significantly changed.

Wrapping It All Up

European macro data have exceeded (low) expectations, though corporate earnings have been lackluster. The good news is that this was (and still is) somewhat priced in to valuations, and that growth outside the Eurozone has been much stronger. Surveying the landscape, European equities remain attractive on both a relative and absolute basis, while in fixed income, high-yield and Eurozone sovereigns, which offer record-low yields, seem vulnerable under several scenarios.

Several risks should be carefully monitored. While the ECB this month has taken further action, it remains to be seen whether it will succeed in curbing deflation and credit contraction. Markets may be overestimating what the ECB can achieve and underestimating the risks if structural reforms are delayed and growth (and thus profits) remains stagnant. In the United Kingdom, a stronger domestic economy may cause rates to rise and hurt bonds, but it also offers a supportive backdrop for stocks. However, many UK-listed companies rely on emerging markets sales and need to see those countries rebound, even as some may be moving the opposite direction. Weaker currencies would help both UK and Eurozone corporate profits, but policy options are not straightforward and a recovering economy and asset markets do not seem to sync with a depreciating euro. We have no crystal ball for currency forecasting, but encourage non-local investors in European equities and bonds to hedge currency exposure. Doing so leans in favor of valuations and should help reduce downside risk if outflows by foreign investors push both stocks and currencies lower. ■



Contributors

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Exhibit Notes

Eurozone Central Government Debt
Source: International Monetary Fund - World Economic Outlook Database.
Note: Data for 2014 are IMF estimates as of April.

Relative Performance of MSCI Europe and MSCI World
Sources: MSCI inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Composite Normalized P/E Ratios
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: The composite normalized price-earnings (P/E) ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and return on equity–adjusted earnings. To minimize the impact of bubble periods on valuations, we have excluded the years 1998–2000 from our historical average and standard deviation calculations.

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European Bond Returns
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Currency Valuations
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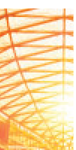
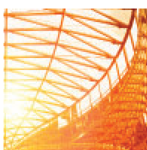

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