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Investment Publications Highlights

CAMBRIDGE ASSOCIATES LLC

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"Ride the Tightening"

John Bilton et al., Bank of America Merrill Lynch,
June 12, 2013

Markets have been hyper-attentive to recent statements by the Federal Reserve, suggesting that any tapering of QE3 could lead to a rise in interest rates. History has demonstrated that rising interest rates tend to bode well for European equities relative to their U.S. counterparts. However, the particular sectors within the European equity market that will perform well depends on whether the rise in interest rates is gradual or steep.

Recent market volatility has demonstrated that investors are closely monitoring the Fed's plan to taper its asset purchases. In Europe, the situation is further complicated by the European Central Bank (ECB) moderating its dovish tone. As "riskless rates" such as the yield on the ten-year U.S. Treasury edge higher in reaction, history suggests there will be positive implications for European equities. However, the path to higher rates will profoundly shape sector performance within European equities.

In an environment of rising rate volatility and higher yields, history shows us that European equities tend to outperform their U.S. counterparts. An old "rule of thumb" states that whenever the U.S. economy is doing well, emerging markets and European equities may outperform the lower-beta S&P 500 Index, and when the U.S. economy is healthy, so, too, is the global economy. Some would argue that the structural issues facing Europe, combined with domestic risks and damaged investor sentiment, render any historical comparisons less valid. But equally, fears over underperformance given monetary tightening are overdone. European Union equities already price in a lot of bad news; relatively cheap valuations and a stabilizing economy suggest they actually may outperform.

Despite record unemployment rates and continued deleveraging in the financial sector, European economic data are beginning to show signs of stabilization. PMIs, credit flow, and industrial production are all improving (albeit from historic lows). Economic expectations are so depressed across Europe that even this stabilization of data at low levels allowed the Eurozone economic surprise indices to inflect over the past few weeks. Despite this, European stocks remain the most underweight region globally, and are the only equity market to see net outflows year-to-date. Within EU stocks, those that are sensitive to the domestic economy are the most under-owned. While the steep discounts to U.S. equities from a year ago have now closed, EU stocks still remain cheap on a price-to–book value and Shiller price-earnings basis. Granted, consensus estimates of 13% earnings per share growth in 2014 may prove overly optimistic, but mid-to-high single-digit growth is conceivable. The bull case for European equities is underpinned by low expectations, light positioning, and inexpensive valuations. With a stabilizing macro backdrop, there is scope for upside.

The path of rising bond yields will be a determining factor in European equity performance. Typically a rotation from safe-haven bonds to equities is a multi-year process with a gradual rise in bond yields. If this scenario plays out (as the Fed hopes it will), bond-like, defensive stocks will suffer and cyclical sectors like financials will outperform as higher rates point to a gradual recovery and not just the withdrawal of liquidity. If the rise in rates is disorderly, there will be broad impacts on markets. Equity risk premium typically do not compress quickly, so if the rates increase too rapidly multiples may

simply contract and defensives would initially outperform in risk-off markets. However, over the longer run, early-stage cyclicals would still outperform defensives. In recent weeks it is worth noting that real rates have risen given higher nominal rates and lower inflation expectations. This is a sign of confidence that economic growth will continue, but this may be overdone given the need for low rates to help manage debt burdens.

Given the likely gradual rise of bond yields over the next few years, investors should consider allocating capital to European equities—specifically within cyclical and financial sectors. However, inflation expectations should be monitored, because if these remain subdued, financials should fare well but the outperformance of other cyclicals is less likely.

"Europe and the Three Tail Risks"

Dhaval Joshi et al., BCA Research, May 30, 2013

As the United States continues its drawn-out recovery, Europe is still mired in a recession marked by high unemployment rates and government austerity measures. Policymakers have made significant progress and have addressed two tail risks that threatened economic recovery in the region. Although the ECB has yet to develop a credible resolution for dealing with insolvencies in the banking system and sovereign bond market, some attractive opportunities exist in European markets for investors with lengthy time horizons.

Policymakers have identified three big tail risks and countered two that threatened future growth in Europe. The removal of the third will take more time, but it does not alter that attractive opportunities exist for investors in European markets. Unsustainable debt dynamics was the first tail risk to be identified and countered. Over the past few years, rising yields on government bonds in peripheral countries threatened debt sustainability. When bailouts for countries like Greece failed, the ECB addressed the issue through the LTRO program. However, when this, too, came up short, the ECB created the OMT program. Since Draghi's famous pledge to do "whatever it takes" to preserve the euro, the ECB has not spent a single cent purchasing government bonds, and sovereign yields have compressed dramatically, improving sustainability.

The second tail risk threatening the economic recovery in Europe is government austerity. In recent years, policymakers have worked to rein in spending, but as a result, growth has suffered. In cases where the fiscal multiplier was greater than one, austerity became counterproductive and debt dynamics worsened as GDP shrank more rapidly than deficits. For the Eurozone, the good news is that frontloading the pain should open the doors for less fiscal drag in the coming years. Based on planned spending cuts, the fiscal drag for countries like Italy and Spain is projected to improve dramatically. Unemployment remains high, but thankfully, it appears that peak austerity is over.

Some Europe bears argue that Eurozone economies need to rebalance, but in reality, most of the "problem economies" have made significant inroads to adjusting their budget balances. In the years before the recession, many European countries became uncompetitive. However, thanks to recent austerity, the majority of European countries are now competitive compared to their top 20 trading partners on measures such as unit labor costs and GDP deflators. Of course Germany remains hypercompetitive in comparison, but this is not the result of productivity. Wages in Germany have

been depressed for a very long time, creating an imbalanced economy based solely on exports. Germany is rebalancing its economy to mirror positive attributes of other Eurozone constituents (increased wages, domestic consumption, etc.). This will help the overall internal imbalances in Europe without putting all the strain on other nations.

Despite the huge progress made in Europe, one significant tail risk remains. Eurozone banks and sovereign bonds remain inextricably linked, meaning that the Eurozone still cannot cope with bank insolvencies. Because of the rigid political structure of the European Union, a troubled banking system inherently means a troubled sovereign bond, and *vice versa*. Winners and losers are therefore defined by national boundaries. The European Union needs to develop a credible resolution mechanism for dealing with insolvencies in the banking system or in sovereign bonds not involving the transfer of wealth across countries. This would come with the creation of a banking union, which many think is plausible but likely still years away.

While the largest gains are likely behind us, investors should expect further convergence between core and peripheral bond yields. As rebalancing efforts continue, and Germany, for example, transitions to a more balanced economy, relative sector performance will also shift. Relative performance across countries should also converge, as investors realize countries like France are more similar to Italy than Germany. Finally, the broader European stock market has massively underperformed the U.S. stock market in recent years. Eurozone equity prices relative to those in the United States are still close to a 40-year trough. For long-term investors, European equities offer great value versus other major markets, especially the United States. ■