CAMBRIDGE ASSOCIATES LLC

INVESTMENT PUBLICATIONS HIGHLIGHTS

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Investment Publications Highlights

Summarized by the Investment Strategy Research Team

"The New Eurozone Political Geometry: What Economic and Market Implications?"

Tina Fordham, Willem Buiter, and Jonathan Stubbs, Citigroup, May 14, 2012

Recent election results in Europe reveal that the fragile consensus behind austerity is starting to break down. As anti-establishment sentiment grows, a new, more fluid political geometry is taking over, complicating the world for investors. European equities may offer well-researched investors discounted assets with strong outlooks, but they should be aware that outcomes like a messy Greek exit or earnings recession are not baked in to current share prices.

Recent election results in Europe reveal that the fragile consensus behind austerity in the periphery and tolerance for bailouts in the core is starting to break down. As anti-establishment sentiment grows, a new, more fluid political geometry is taking over, featuring a revolving door of leaders, extreme political parties, and ever-shorter political honeymoons. This complicates the world for investors: how do they forecast the ways in which continuous political adjustments complicate necessary fiscal and structural changes? Some of this uncertainty is baked in to share prices, but a messy outcome like a Greek exit or earnings recession is probably not.

Anti-establishment sentiment can be measured by declining support for existing political parties. Just 4% of Italians support the main parties, and in the recent Greek elections only 30% of the public voted for either of the two main parties. Markets, by continuing to treat these election outcomes as discrete events, may be under-appreciating a shift toward a more fluid environment. There are risks for investors from a revolving door or newly elected leaders who have ever-shorter honeymoons. One is that these leaders lack the legitimacy to pass meaningful reform or demand sacrifices. Another is the creation of a vacuum that allows extreme parties to gain influence, increasing the likelihood of political paralysis, at best, or even far worse outcomes like euro exits.

François Hollande's victory in France is unlikely to obviate the need for austerity measures, though it may inspire similar campaigns in Greece and other European countries. However, "growth" is not really a policy in and of itself, but rather the result of good policies, institutions, a stable environment, healthy credit markets, and a little luck. Delaying austerity is only possible, furthermore, if markets will provide funding as an economy shifts from fiscal unsustainability to sustainability. Market funding may be an option for countries like Germany, Japan, and the United States, but it is definitely not an option for peripheral Europe and probably even the soft core (Belgium, France, etc.). The European Central Bank (ECB) likely will be pushed to help fill this void, but investors should recognize that this may mean an increased chance of private sector bail-ins for sovereigns and possibly even bank restructurings.

Fluid political geometry also raises the likelihood that Greece will exit the Eurozone. While 70% of voters say they want to stay, an equally sizable percentage rejects the bailout agreement with the so-called troika. These voters fail to understand that such a rejection would see €90 billion of aid

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cut off. The party rising in the polls, Syriza, also fails to grasp this fact, and its lack of previous involvement in negotiations may mean it lacks an appreciation that core Eurozone leaders may be done throwing good money after bad. In fact, these core leaders would be better off using available funds to limit the fallout from either a Greek exit or a complete breakup of the Eurozone, events that are now increasing in probability.

These unhelpful political dynamics present a depressing backdrop for Europe's economy and equity markets. While European share prices already reflect a plethora of bad news, they do not price in a Greek exit or a collapse in profits or global recession. However, investors should recognize that Europe possesses many companies with high levels of non-European exposure and strong balance sheets. Well-researched investors will likely be able to find discounted prices for companies with strong outlooks, but they should focus on quality companies.

How much of the current crisis is baked in to European equity prices? Within European equities, the epicenter of the crisis has been peripheral markets and financials. Peripheral markets sit 60% to 90% below their 2007 peaks, similar to crashes seen in previous emerging markets crises. However, European policymakers have fewer policy tools to respond, and in particular cannot devalue their currencies. European banks now trade at 0.4 times book value, the lowest level since March 2009, suggesting bank shares already account for dilution and write-down risk. However, if you back out financials, the market only trades at about a 10% discount to its historical price-to-book (P/B) ratio. In other words, equities look attractively valued, but are not sending out a definitive buy sign.

A similar discrepancy can be found when comparing northern and southern European equity markets. The southern block (Greece, Ireland, Italy, Portugal, Spain) now trades at around 75% of the P/B of northern markets, down from around 95% prior to the credit crisis. This discount reflects sovereign debt concerns, but also weaker profit and growth trends. While eventually this may present an opportunity, for now investors are better off paying up for growth. An additional place to hide may be companies with substantial amounts of emerging markets revenue, such as consumer and luxury goods champions.

"European Strategy: From Despair to Where—The Long-Term Outlook for EPS Growth and Equity Valuation"

Graham Secker, et al., Morgan Stanley, May 8, 2012

Investing in Europe over the past five years has been a dismal experience for investors, with returns ranking in the bottom 5% on both a nominal and real basis. Now, investors are left to wonder where they are headed following this dismal experience—off to a prosperous five years, or off to five more dismal years.

Investing in Europe over the past five years has been a dismal experience for investors, with returns ranking in the bottom 5% of historical results on both a nominal and real basis. Now, investors are left to ponder where things are headed, and whether we are at an attractive entry point. The lessons from Japan in the early 1990s suggest a rebound should not be assumed. The performance of the last five years in Europe is a result of both negative earnings growth and falling valuations, an uncommon double whammy last experienced in the 1970s. Going forward, total returns should be closer to historical norms, but the lack of credible solutions to current macro problems merits a cautious short-term stance.

When considering the outlook for earnings, it is important to look at trends in sales and margins. Currently, the developed markets consumer lacks confidence, and suffers from low disposable income growth and deleveraging. While weakness in disposable income growth may continue, there is some scope to reduce saving to spur further borrowing. The emerging markets consumer seems to offer better prospects, as rising wages and low debt levels make this exposure attractive for corporates. Improved corporate spending could also boost revenues, given that the sector has a healthy balance sheet and capex levels are low versus history. However, a pick-up in confidence, helped by macro stability, is essential for this to occur. Finally, the government seems unlikely to pick up spending given the focus on austerity measures, which in turn will impact consumer expenditure (keeping in mind the government employs 24% of the labor force in the Eurozone) and business confidence.

With limited scope to grow the top line, margins and return on equity (ROE) expansion will need to drive corporate profit growth. Margins that were close to record highs in 2011 leave limited room for expansion and have been associated historically with earnings per share (EPS) growth of only around 1% to 2% per annum. However, as European corporate ROE is near long-term averages (12%), this could be a bigger driver of EPS growth, especially if companies are able to use the high level of cash on their balance sheets wisely. Splitting the difference between the conflicting signals, we assume a five-year EPS compound annual growth rate of 4%.

Aside from earnings, the other factor impacting total return is valuations. There are seven main factors that investors must consider when analyzing valuations: the historical period for comparison; whether to measure static or cyclically adjusted ratios; whether to use absolute or relative valuation metrics; the relationship between inflation and price-earnings (P/E) ratios, the relationship between P/E ratios and EPS growth and volatility; the relationship between P/E ratios and fund flows; and, finally, the impact of geopolitical uncertainty on P/E ratios.

Modest valuation levels in Europe reflect market concerns over some of the structural issues afflicting developed markets economies. While some may analyze current valuations with respect to more recent (post-1987) averages, this may lead to spurious conclusions given a once-in-a-lifetime credit bubble and the macro dynamics associated with the debt supercycle. Instead, investors should focus on longer-term averages. Comparing current valuations to longer-term series shows Europe as undervalued on a post-1970 basis and the United Kingdom as undervalued on a post-1927 basis. However, investors should stress using "normalized" valuation metrics rather than static P/E ratios, as they are proven to have greater explanatory power with respect to long-term returns (but understand that they may lack signals for short-term performance). For example, U.K. equities trade at a 15% discount to their long-run trailing P/E; however, the current 13.2 Shiller P/E is modestly above its long-run average of 12.7. The 11.9 MSCI Europe Shiller P/E, in contrast, is well below its historical average.

Next, while investors should look at valuations on both an absolute and relative basis, an important question in today's investing environment is: "Are low bond yields good for equities because they boost the latter's relative valuation or are low bond yields representative of a weak macro environment, which suggests equity valuations should be low?" The relative valuation gap may appear to make equities cheap today, but it is increasingly important to understand why bond valuations are so expensive. In fact, low bond yields historically have not been an indicator of high subsequent equity returns.

Rates of EPS growth also affect valuations, and today's level of EPS growth in Europe is associated with a forward P/E ratio that is slightly below historical averages. Finally, when looking at the outlook for European equity valuations, it is important to recognize that geopolitical tension and political uncertainties also play a role. Equity markets hate uncertainty and usually demand lower valuations. In addition, high debt levels and deleveraging trends have long led to an uncertainty discount. However, central bankers have provided an offsetting tailwind in the form of quantitative easing, which can lead the way to valuation expansion. For example, valuations for U.S. equities have tended to rise during periods of the Federal Reserve's monetary stimulus while similar behavior regarding Europe occurred under the ECB's Long-Term Refinancing Operation. Going forward, a high level of macro uncertainty is likely to prevail, but the base case remains a muddle-through scenario.

So what exactly does this mean for the next five years? Earnings growth should remain relatively muted, but valuations should gradually creep higher. One reason is that earnings volatility will be lower, another is that reduced macro uncertainty will encourage some asset allocators to shift back to equities. Reduced geopolitical uncertainty will also result from continuous monetary easing, further reducing the uncertainty discount. Given the prospects for moderate P/E expansion and EPS growth, one can expect five-year total returns in the ballpark of 8%. ■