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The Global Equity Horserace: An Update on Europe

"Down the stretch they come"

The month of March marks a couple of key milestones in recent investor lore. On March 9th 2000, the NASDAQ broke through 5000 and peaked one day later at 5048 (the only two days the index closed above that mark). Fifteen years later, the index is once again poised to break through the momentous level as it rests at 4976 at the time of this writing. March 9th also marks the sixth anniversary of the current (U.S.) bull market which has taken the S&P 500 index from a then low of 676 to a late February high near 2115—a gain of over 1440 points! The nearly 230% gain has led most major global indices and vaulted the S&P 500 back into the spotlight as the world's darling, fulfilling our 2011 *SEIA Report* hypothesis that "the time will soon be upon us when stocks again regain their status as king of the investment choices." While the media will focus on the NASDAQ and compare and contrast 2015 with 2000, we believe that it is more prudent to analyse the S&P 500 and compare today with the economic landscape of just a few years back. Our conclusion? The biggest gains from U.S. stocks may be behind us as the world's thoroughbred rounds the last turn in this business cycle.

Six years into an economic cycle is bound to bring on some changes. In every bull market, as it matures, consumer sentiment improves. It's only natural that we should collectively feel better as our stocks gain wealth. However, "happier" investors tend to become exuberant over sustained rallies, and eventually greed begins to take hold. As the herd mentality sets in, prices move ever higher—until ultimately valuations become too stretched and the inevitable downslope of the business cycle begins (it's called a cycle for a reason) as equity prices correct. While leading economic indicators are not currently pointing to a recession, valuations clearly are stretched. So much so, that current valuation measures are now higher than at any point in post-WWII history (with the exception of the possibly once-in-a-lifetime technology/dotcom bubble).

A year ago we published a piece, "Do the Math" in which we broke down the variables that drive stock prices (if math isn't your thing, skip to the next paragraph). In short, a stock's Price will equal the stock's Earnings multiplied by a Valuation Multiple (P = E x P/E). Stocks can <u>only</u> go up (P) if investors are willing to pay a higher multiple (P/E) or if the stock earns more money (E). If one believes that today's era of high P/E's are near their top, then stocks can only go up if corporate earnings increase.

However, large increases in corporate earnings do not appear likely. Why? At the beginning of the cycle, the underlying earnings of U.S. corporations benefitted from a weaker dollar, stimulative monetary policy with falling interest rates, and low labor costs. Six years later, all of these metrics are reversing. The Dollar just hit an 11-year high; the Federal Reserve has already tightened monetary policy by ending QE and may now raise rates later this year; and wages are just starting to rise evidenced by the recent announcements from Wal-Mart, TJ Maxx, and several state-mandated minimum wage increases. With marginal growth in earnings (the E) and near record valuations (P/E), there's little remaining catalyst to drive up stock prices (the P) in the same way that investors have experienced in recent years. Understanding the underlying variables and catalysts to equities helped investors get into U.S. stocks in 2009 and again in 2011. But six years later those fundamental metrics are arguing for a reduction in U.S. equities. Fortunately, there are other business cycles around the globe where lower valuations, higher earnings growth, and easier monetary policies afford greater investment opportunity. Savvy investors should take note.

The Trifecta

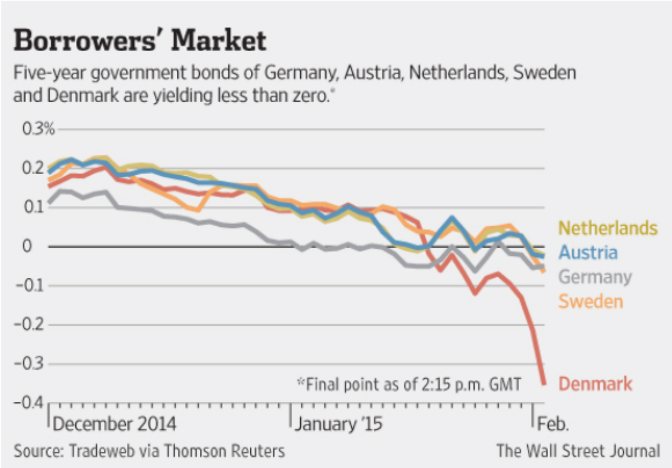
Readers may recall that a while ago we highlighted European stocks as an area that was becoming attractive – offering a "trifecta" of benefits that included higher dividend yields, higher earnings growth and lower valuations. To review:

1. **Yields:** Europe's dividend yield near 3.3% at year-end was higher than its own 20-year average, and 69% higher than the dividend yield on US equities.
2. **Earnings Growth:** According to consensus estimates, European earnings are projected to grow 20% over the next two years, outpacing both the U.S. and the rest of the world.
3. **Valuations:**
    a. **Absolute:** European stocks are cheap compared to their own historical averages. According to Brandes Investment Partners, at year-end the price-to-book ratio for European equities was 22% lower than the 20-year historical average, while the Cyclically Adjusted Price-to-Earnings (CAPE) ratio was 31% lower. The CAPE ratio is similar to a traditional P/E ratio except that it factors in multiple years of earnings in an effort to capture an entire business cycle. While it's no guarantee, historical analysis reveals that when Europe's CAPE has been at similar levels, equities have averaged double digit returns for the subsequent three-year period.
    b. **Relative (to other stocks):** European equities look attractive relative to U.S. equities, trading at an 8% discount to U.S. stocks based on P/E ratios, a 38% discount based on price-to-book ratios, a 28% discount in terms of price-to-cash flow, and a 47% discount based on their CAPE ratio (the largest discount level seen in 30 years, during which the average discount was 18%).
    c. **Relative (to other investments):** Relative to bonds, European stocks appear highly attractive. A 6.2% earnings yield as well as a 3.3% dividend yield compares quite favorably to a 0.30% (no, that's not a typo!) yield on a 10-year German Bund.

Although European equity opportunity is not new news, we fortunately now have a new set of *Tailwinds* that can further drive gains in overseas stocks.

"And they're off"

Monetary Policy (Conventional): Recall that in 2008, the Central Bank of the United States (The Federal Reserve) moved short-term interest rates to zero to help stimulate and promote economic activity in the midst of the Great Recession. However, the move may have had its most profound impact in the capital markets. The Zero Interest Rate Policy (ZIRP) frustrated conservative investors as their cash and short-term bonds would now earn next to nothing. Stymied by a 0.01% yield, investors moved assets out of conservative cash and into riskier asset classes in search of yield. The primary beneficiaries were higher yielding securities such as corporate bonds and dividend-paying stocks. Six years into ZIRP, investor demand has pushed up equity prices by over 200% and has subsequently moved valuations to levels not seen outside the technology/dotcom bubble of the late 1990's. Although investors today rarely have a six-year window of opportunity, one can argue that Europe is now in a similar position to where the U.S. was just a few short years ago. In mid-2014 the European Central Bank (ECB) responded to the weak economy by lowering short-term interest rates on banks deposits held with the Central Bank. But unlike our move to zero, the ECB moved interest rates into *negative* territory (NIRP?). As expected the move, along with hints of other more unconventional monetary policy (see below), had investors clamouring for yield, pushing European sovereign debt down to once unthinkable levels. A staggering $3.6 trillion (16%) of Developed Markets global government bonds now trade at negative yields to maturity. Using Switzerland as just one example, as of January 27th a 3-month Swiss bond was yielding -1.30%, the two year bond was yielding -1.00%, and the longer duration 12-year bond yield stood at a staggering -0.01%! Why the low yields and corresponding high prices? Perhaps it's all an attempt to front-run the ECB's next move—Quantitative Easing.



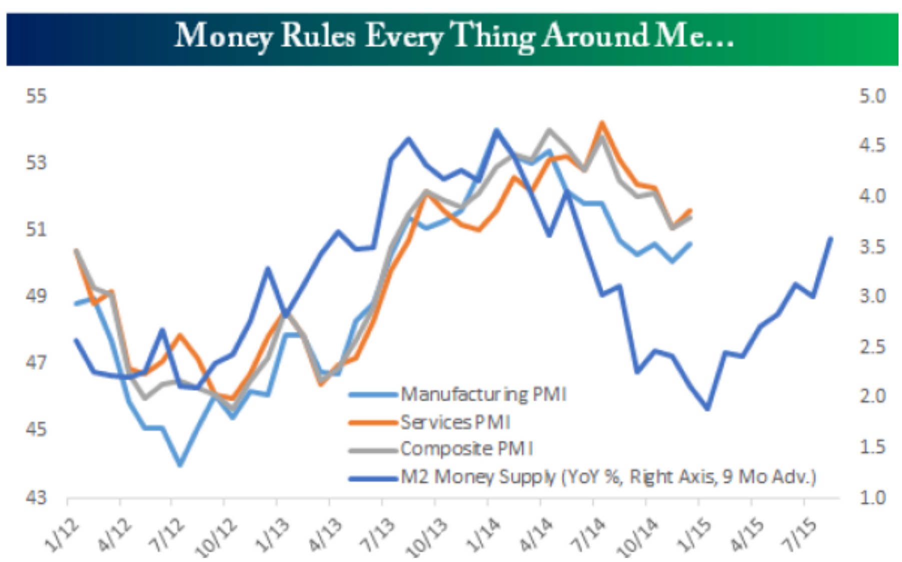
Monetary Policy (Unconventional): You could say that Europe is late to the party. Following the likes of the Federal Reserve (2008, 2010, 2012), the Bank of Japan (2010, 2011, 2013, 2014), the Bank of England (2009, 2010, 2011, 2012), the Swedish National Bank (2015), and the Swiss National Bank, the European Central Bank (ECB) in January announced a quantitative easing (QE) program of their own. The program, which is set to begin in March, will run until the end of September 2016 with the ECB purchasing at least €1.14 trillion of securities.

While QE cannot directly stimulate growth, it directly pushes three primary levers (inflation expectations, interest rates, and currencies) that can indirectly help the economy. Deflation can wreak havoc on capitalism, and QE can serve to break the vicious downward spiral in which economic weakness creates deflationary expectations which delay consumer consumption which in turn leads to further economic weakness. Since the announcement of the program, break-even inflation rates have started to move upward suggesting that the deflationary mind-set has started to recede. Second, QE can hold real interest rates lower for longer, thereby allowing market participants to borrow cheaply, repair balance sheets, and promote investment to help generate growth. From the initial hint of QE, the 10-year German Bund's yield-to-maturity moved from near 1.50% to an astonishingly low 0.27%. Even higher risk countries like Italy and Spain are yieldi~~ng~~ less than 1.35%.

Finally, QE can weaken a country's currency (or in this case, the European *region's*) by not only changing the "supply" makeup of the currency but also the "demand" characteristics as well. Think Econ 101: Increased supply of a good leads to lower prices. By "printing money", the amount of Euros increases which should equate to a lower price translated by the exchange rate. And by driving yields down, investors are forced to look outside of their own borders to seek income. Reallocating their portfolios overseas creates a mass financial exodus out of the European region and thus out of the euro, dramatically impacting the "demand" for that currency. All in all, increased supply in conjunction with lower demand should greatly affect the price of the underlying good—in this case, the currency itself. Again, from the time the starting gun went off in mid-2014, the euro fell from $1.35 to a recent $1.08 as of early March.

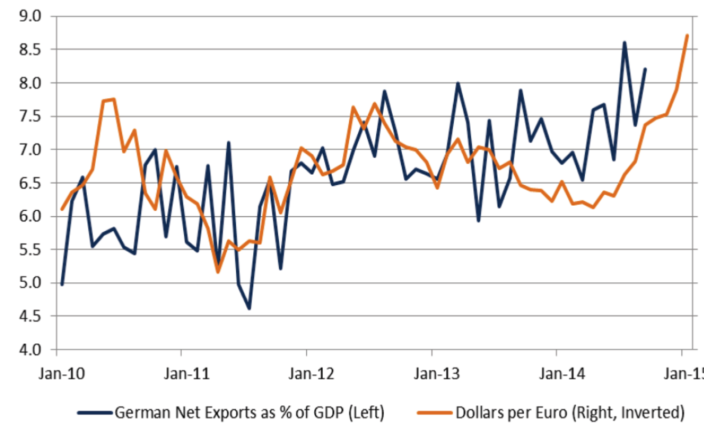
The Backstretch: Translating into the real economy

To recap, QE affects inflation expectations, interest rates, and currencies first. These changes in the economic landscape then typically work their way into the system creating positive by-products for European corporations. <u>Low interest rates</u> tend to improve Consumer Sentiment, which has already seen recent signs of improvement. "Happier" consumers spend and invest more (low interest rates spur demand) which translates into "happier" corporations. Recent signs across the European economy show businesses wanting more credit in preparation for increased future borrowing. This translates into both increased loan activity for banks as well as increased production for the borrowing company—an unambiguous positive for Eurozone growth. And as evidenced in the adjacent chart, credit growth leads to higher demand which leads to higher orders and production. According to Bespoke Investment Group, the growth of the money supply (catalyzed by bank lending) typically predates an increase in activity by nine months, and therefore signals a solid upturn for manufacturing over the coming three quarters.



A lower currency can raise corporate profits. U.S. multinational companies have increasingly cited the impact of dollar strength as a headwind on earnings growth potential. What serves as a headwind for U.S. corporations, however, acts as a tailwind for Eurozone companies on the other side of the relationship. European exporters now have a huge advantage when they compete against foreign companies (think BMW vs. Cadillac) as they can either cut prices and maintain profit margins, or hold prices steady and watch profit margins and earnings mushroom. And the benefits are even more so in Europe. Investors must remember that many Europe-domiciled corporations are quite diversified and derive a smaller portion of their revenue (46%) from their home region than do most U.S. corporations (66%), according to Bespoke. Exports are huge in Europe. With half of the world's top 10 goods-exporting countries domiciled in Europe, the region accounted for 58% of total exports in 2013.

WEAKER EURO SHOULD BENEFIT EXPORTERS



Source: FactSet; data through January 31, 2015. For illustrative purposes only.

This all bodes well for a rebound in corporate profits in Europe, which recently stood about 14% below their 10-year inflation adjusted average. According to Brandes, corporate profits are one of the most mean-reverting data series out there (meaning they tend to go back to historical averages). Europe offers a contrasting picture to what investors see in the U.S., where profits have been about 25% above the 10-year average. For investors to be rewarded, Europe doesn't need to post eye-popping numbers…it merely needs to "catch-up" with the United States. Remarking on the dichotomy of the world's two largest economies, Briefing.com recently stated, "There is a lot of room for improvement in Europe, while the S&P 500 is running into thoughts of resistance that its best days of earnings growth velocity are behind it for this cycle."

The winning ticket?

Investors in Europe are beginning to see some green shoots; consumer confidence is on the rise, bank lending is up, and German joblessness recently fell more than forecast. And the stock markets are starting to come to life, as European stocks have handily outpaced U.S. stocks so far in 2015 and outgained them over the last twelve months through the end of February. Unfortunately, many U.S. market investors have not experienced such profits—especially in 2014. Why? The gains of assets overseas have to be translated back into a stronger U.S. dollar, which as we explained is a headwind for U.S. domiciled companies and investors. Fortunately, we may be past the halfway point in Europe's currency devaluation and U.S. investors may soon reap the rewards.

Decent valuations—check. Good yield—check. Rebound in earnings due to favourable monetary policy—check. Investors may be well rewarded to diversify out of the U.S. if they have not done so already. In other words keep the show horse, but take recent winnings and reallocate overseas to breed the next generation of winners.

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