Europe: Prospect or Pariah

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From August 13 to September 30 the MSCI Europe price index outpaced the MSCI USA price index by 2.8%. After the persistent underperformance of the region since the global recession, that positive spread seems to have caught the attention of investors who have begun to ask if Europe is bottoming and due to enjoy a period of outperformance. On one hand investors could dismiss that short burst since the positive relativity has reversed in October and November. But smart investing often depends on identifying opportunities and acting on them before the trade becomes consensus. At present, there is an argument to be made that some of the European fundamentals offer some attraction.

Value Play

One could contend that a bet on Europe is actually a bet on value stocks. Exhibit #1 compares the Value and Growth sector biases of Europe and the U.S. The European weighting in the two sectors traditionally containing the most value stocks (Financial and Consumer Staples) is 12% higher than in the U.S., while its weighting to the two traditional Growth sectors (Information Technology and Consumer Discretionary) is only half that of the U.S. Most of the U.S. Growth bias can be attributed to the concentration of Technology companies in the U.S. and the lack of representation in the sector in Europe. That means other sectors mathematically are overweight in Europe compared to the U.S. Value sectors pick up much of the slack. So is the difference a Value bias or a sector bias? Maybe a bit of both.

Exhibit #1 MSCI Sector Weight	Europe	USA
Traditional Growth	15.9%	32.9%
Information Technology	5.8%	22.6%
Consumer Discretionary	10.1%	10.3%
Traditional Value	32.0%	20.1%
Financial	17.8%	12.9%
Consumer Staples	14.2%	7.2%

An argument that sectors are the driver of relative returns gains support from the fact that Information Technology has been the best performing sector in the MSCI All-Country World Index since the market bottomed in March 2009, outpacing both the Financial and Staples sectors by more than 6% a year in USD terms. And the rally in Financial stocks in the last three months lends some credence to suggesting that the recent European rally was supported by its largest sector.

The Value/Growth cycle

While the sector weight argument is logical, ask any Value investor and they will tell you the cycle between value and growth in the U.S. has also been strong. They have waited for years for other investors to remember that value criteria have historically been some of the strongest drivers of relative stock returns. That has not been the case for most of this economic expansion and bull market either domestically or globally as seen in Exhibit #2. Other than a few short reversals, the underperformance of the MSCI World Value index compared to the Growth index has been consistent for about ten years. That is a long time for value investors to wait for the reversion they depend on. It also suggests the trend is due to more than just the difference between Information Technology and Financials returns. Given the European concentration in value stocks it is also consistent with the pervasive underperformance of Europe compared to the U.S. in recent years. But is there a change in the wind?

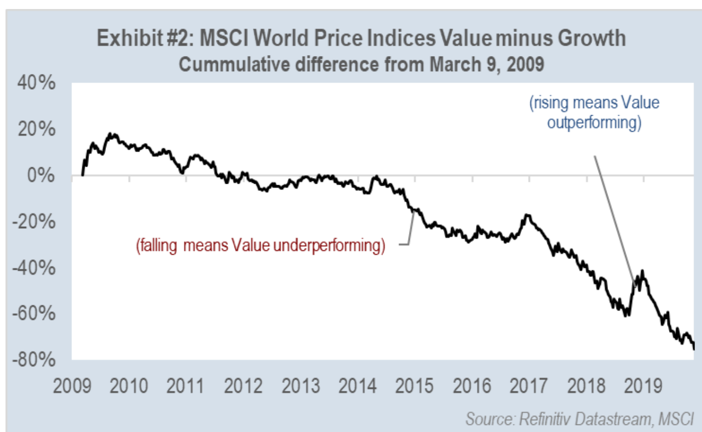


Exhibit #2: MSCI World Price Indices Value minus Growth
Cummulative difference from March 9, 2009

At the Extreme

The strongest case for shifting equity allocations toward Europe actually is the valuation relationship. Since the European index contains more value stocks than the U.S. index it is not surprising that it almost always looks cheaper, as seen in Exhibit #3 on the next page. On average the Forward Price/Earnings ratio of MSCI Europe is only about 86% of that of the MSCI USA index. The magnitude of that cheapness can vary widely. The

(Continued on page 2)

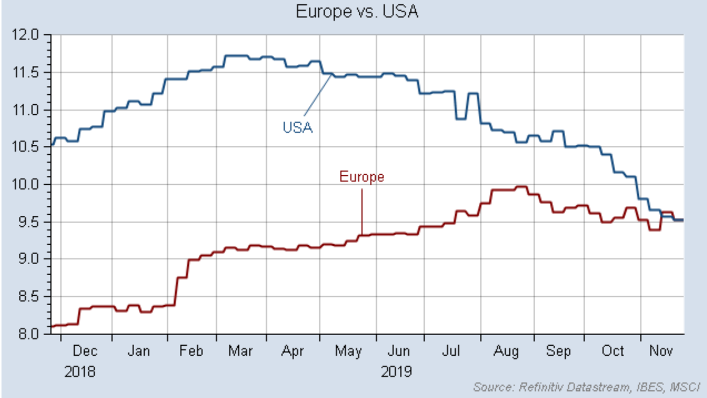
Exhibit #3: Europe P/E divided by US P/E

current 80% reading is below -1 standard deviation, favoring a return to the mean at some point. But markets can be undervalued for extended periods of time. In fact, this ratio has been hovering around -1 standard deviation for over a year now. In addition, the valuation gap does not necessarily resolve itself with Europe outperforming. Europe did not outperform the U.S. in either of the two prior instances of -1 standard deviation since the beginning of this bull market in 2009. That is even if you timed the turn in the valuation gap perfectly. It appears that some kind of a catalyst is required for an effective allocation shift. That is why U.S. bulls find it so easy to dismiss this valuation discrepancy. But long periods of U.S. outperformance tend to breed complacency and an opportunity to profit if you are vigilant in watching for catalysts.

A Search for Growth

Earnings per share growth in the MSCI USA index has exceeded that of its European peer in eight of the last ten years including expectations for 2019. Why get excited about Europe when the two largest countries are flirting with recession and U.S. earnings are expected to have a bit of a rebound next year? As investors search for earnings growth in a low growth world, Europe does not seem to be the logical rock to turn over. But expectations for 2020 earnings growth in the U.S. have been contracting since March. In contrast, European growth expectations were on the rise through August and have held up better over the last three months (Exhibit #4). At the last tick 2020 European earnings growth is

Exhibit #4: Expected EPS Growth in 2020
Europe vs. USA



expected to exceed that of the U.S. In addition, European companies have not been on the buyback binge that their U.S. peers have indulged in. Therefore, that earnings growth should be of a higher quality. Could it be that European economic fortunes and expectations are at a low ebb with a nascent rebound in the works?

Never-ending Story

With the ECB pump priming again via quantitative easing, is a new economic dawn just over the horizon in Europe? Unfortunately, that ray of light has failed to turn to sunny skies too often since the financial crisis and investors are justifiably skeptical. Expectations are quite muted at this point. They are so dire that economic data announcements are beginning to surprise on the upside. The Citi Economic Surprise indicator for Europe (Exhibit #5) has been on the rise from very low levels since mid-October and has almost turned positive at this point. Being heavily

Exhibit #5: Citi Economic Surprise Indices

dependent on exports, Germany has been at the nexus of global trade effects from BREXIT uncertainty, the China-U.S. trade war, and the U.S. threat of a European trade war. Data has been in a downward spiral all year. But more recently some encouraging signs are beginning to sprout. Germany's PMI manufacturing survey turned higher in October and extended that recovery in the preliminary November reading. In addition, the 2-10 bund spread has been quietly rising and third quarter GDP avoided the widely anticipated recession. More broadly the Eurozone manufacturing PMI and consumer confidence are also bottoming. Even car registrations bounced at the latest reading. Clearly, these readings are not robust, but they could easily be the first few rays of hope and bear watching.

Can I Get a Loan?

A strong banking system is generally a prerequisite for a robust economy and the European banks have been a bit of an Achilles heel since the financial crisis. Europe was not as aggressive about recapitalizing their

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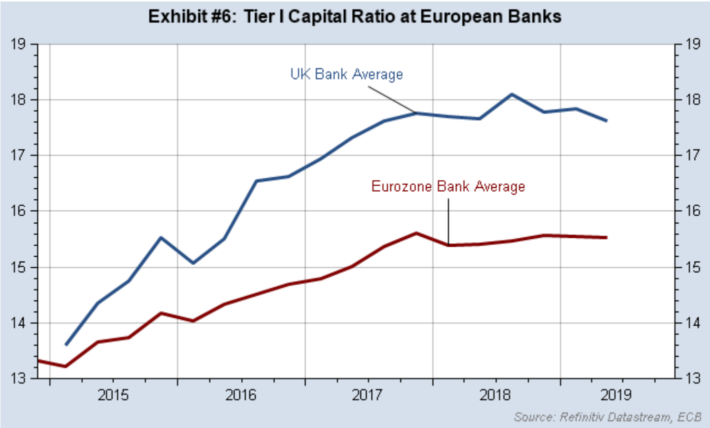
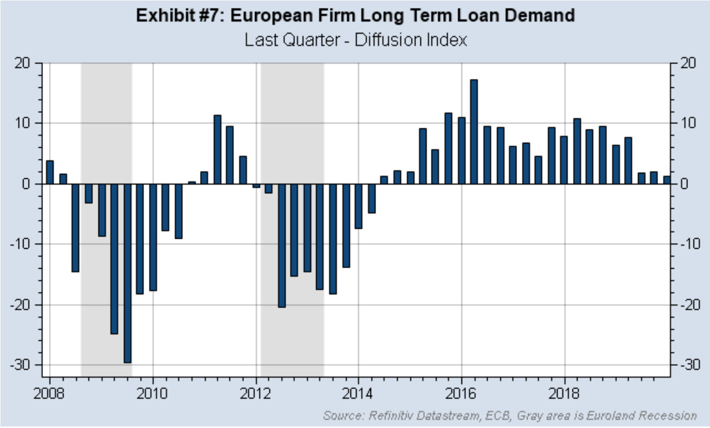
banks as the U.S. However, the health of European banks has improved with little fanfare over the last five years. The improvement in Tier I capital shown in Exhibit #6 could be an indication of their ability to support a more durable expansion once the outlook improves.



But Do I Want a Loan?

While loan demand has not actually turned negative, it has been pretty tepid in 2019 (Exhibit #7). That would be consistent with the pace of economic growth, modest capital expenditures, and the uncertainty created by global trade issues. But when a business delays the decision to invest in its future that also creates a catch-up expenditure down the road. If an economic bottom is being built it could prove to be a catalyst to unlock some investment. We are not suggesting this is a shift that is already in process. Merely that the banking system may finally be in a position to support growth when the turn proves more durable and companies are once again ready to expand.

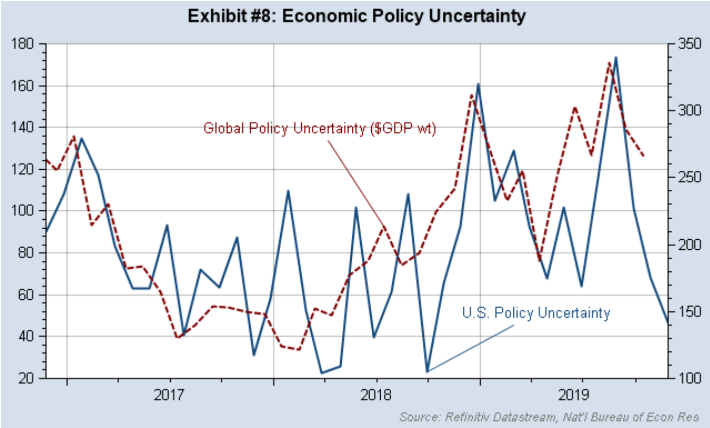


Spending the Surplus

Some question the effectiveness of European monetary stimulus. The results of the last eight years have not been an overwhelming vote of confidence for a flood of liquidity turning into economic growth. But the fiscal surplus of some of the northern European countries and years of repair for some of their weak sisters opens up some room for help if the government spending stranglehold is loosened a bit.

Global Trade

Of course, the trade issues creating the current uncertainty may be around for some time yet. Interestingly, policy uncertainty in the U.S. has normalized from very high levels (Exhibit #8). The reading for global policy uncertainty is still high, yet it is starting to fall from its peak. In the past when uncertainty moderates the stock market has improved as that weight holding prices down is lessened. The potential of Europe has been held back as the old guard leadership has fragmented. It is unclear if the new leaders can pick up the mantle and lead Europe to a more prosperous future, but as new blood emerges there is always a possibility of new beginnings.



Canary in a Coal Mine

In the early days of the PIGS debt crisis the canary in the coal mine was Greece as years of excess spending came back to haunt them and led to years of austerity and bailouts. At this juncture it is too early to call all clear, but new leadership is making progress with economic restructuring and it has garnered the attention of their creditors and investors. Greece is up 42% in local currency terms year-to-date and is the best performing stock market in 2019. Could they once again be a canary in a coal mine, this time for the positive?

When Bad is Good

Some times the best time to take a position in an investment is when issues abound but a turn is in the process of developing. We cannot wholeheartedly endorse a clear European bottom yet, but do believe it certainly bears watching.

The MSCI All-Country World (ACWI) and MSCI ACWI ex-US are free float-adjusted market capitalization weighted indices designed to measure the equity market performance of developed and emerging markets. They include reinvested dividends and are presented gross of fees. The MSCI USA Index is free float-adjusted market capitalization weighted index designed to measure the equity market performance of the large and mid cap segments of the US market. All index performance includes capital appreciation and reinvested dividends and is presented gross of fees.

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