Focus

European Equity markets: risks and opportunities

July 2016

Summer is there …a good opportunity to take a step back and have a closer look at the current risks and opportunities of the European Equity Markets and their implications on our investment strategy.

Overview of the current macroeconomic backdrop

The European macroeconomic environment remains, from our point of view, mixed meaning that despite several encouraging signs of improvement, major short-term (geo)political risks are still very much present.

At the positive side of the balance, we have converging factors that should support the European Equity markets in the coming months: low oil prices (despite recent rebound), improved credit conditions and labour markets, better economic data, rising house prices, end of the extreme fiscal austerity in many countries including Germany and last but not least a still very accommodative monetary policy thanks to ECB's Quantitative Easing (QE). Moreover, according to the research institute GfK, consumer confidence in the European Union has strengthen to reach its highest level since March 2008.

At the negative side, we have different risks that are mainly linked to (geo)political issues: a corrosive Brexit referendum showing that the European integration is a reversible process, difficulties for the French government to govern and implement necessary structural reforms by remodelling the Labour Law, the Italian constitutional referendum in October, the migrant crisis and terrorist threats. Throughout Europe we are evidencing a gain in strength of populist anti-establishment movements all having one common denominator: they are notoriously anti-European.

Our humble opinion is that the European construction has not only brought Europe more than 70 years of peace and stability, the Common Market has brought wealth and prosperity and given Europe a voice as an economic power in a globalized world.

This said, **as bottom-up long-term investors, we think that, even if, in the short- to medium-term, those negative factors are clearly affecting the operating environments of the companies we invest in and create volatility in the European Equity markets, the long-term results of our investment strategy will remain to be solely dependent on 2 factors**: first **the earning power the companies are able to produce** and secondly **the price at which we invest into these cash-flow generating franchises**.

By sticking to this strategy, we will be able to deliver long-term consistent performance.

Value vs. growth: the trend should be our friend

In the past decade, Value strategies have suffered the pain and largely underperformed the overall European Market as well as the Growth segment as shown in exhibit 1 below. 2015 may even be qualified as "Annus Horribilis" for European Value investors with the MSCI Europe Value underperforming the MSCI Europe Growth by 14%.

Exhibit 1: Evolution of MSCI Europe Net TR, MSCI Europe Growth Net TR and MSCI Europe Value Net TR from 31/12/2008 to 30/06/2016. Data in EUR. Source: Bloomberg

This underperformance can be explained by the unappeasable quest for yield that led investors to rush in high yielding dividend stocks regardless of their valuations. This behaviour is a direct consequence of the ultra-lax monetary policies by the ECB pushing interest rates to historical lows (and now into negative territory). The few companies showing growth have been bought independently of valuation pushing prices up.

However, 2016 seems to be a more promising year for value investors. At least the first months of the year have shown signs of a trend reversal with Value regaining some ground vs. Growth (Exhibit 2) even if, over the short-term, the turbulences linked to the Brexit may slowdown the process.

Exhibit 2: Evolution of MSCI Europe Net TR, MSCI Europe Growth Net TR and MSCI Europe Value Net TR from 31/12/2015 to 30/04/2016. Data in EUR. Source: Bloomberg

Investors start to realise that there is a life after QE with increased signs from the Fed withdrawing from its asset buying programs and progressively raising interest rates. While the ECB keeps the monetary bazooka firmly on its shoulders as the European economies are still weak, investors start to look also in Europe closer again at valuations. This clearly gives our strategy some medium-term tailwind.

Back to the roots…

> ***"An adequate combination of low valuation and decent earnings capacity is key for long-term alpha generation"***

The basic driver for long-term value-oriented investors like we are is that the inefficiency of the Equity markets is leading to an excessive volatility of asset prices relative to their underlying value. This underlying value of a business is driven by the fundamentals of the business and the cash flows it is able to produce and not by financial markets.

Our aim is thus to select companies benefiting from strong fundamentals and earnings capacity which stock price is undervalued compared to their intrinsic value.

Over the long-term, valuation matters…

The lasting power of value is clearly evidenced in the below chart (Exhibit 3): **as the time horizon lengthens, the advantage to focus on undervalued stocks is increasing compared to strategies investing in expensive companies**.

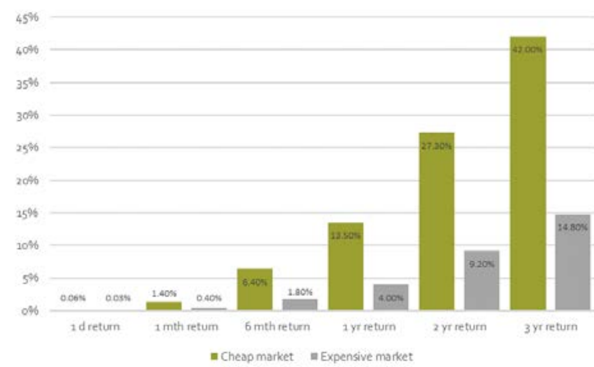

Exhibit 3: Impact of starting valuation on S&P 500 Return (all days since Dec. 31, 1963).
Source: Datastream, GMO, Data from 1964-2016.
Note: the cheapness or expensiveness of the market is determined by the Shiller P/E

However, valuation cannot be considered in an isolated manner. A cheap asset is not necessarily a good investment if the underlying company is not able to produce satisfactory earnings. In order to avoid these value traps and to provide consistent return under changing market conditions, investors therefore need to focus on the ability of the business to generate earnings.

In the more than 15 years we apply this investment philosophy, we found that **combining strong earnings capacity with low valuations usually provides competitive long-term returns**.

Valuation & earnings cycle: current picture in Europe

Having set this general framework of a successful value investing strategy, one can wonder what is our current view on those 2 key pillars.

Valuations remain reasonable

When looking at the long-term valuation measures we prefer like the Shiller PE, the European Equity markets trade below their historical average. The Shiller PE normalizes earnings by averaging them out over a 10-year period and adjusting for inflation. On this measure, European markets also look attractive compared to other Developed markets like the US. This provides, from our point of view, for an ideal hunting ground for very selective stock pickers like us who are chasing undervalued earning power in a universe of more than 1 500 companies.

Earnings cycle in Europe is less advanced than in the US

In a previous note, we were speaking about a "lost decade" for earnings of European companies as over the past years, the stock market appreciation was not driven by earnings growth but by the ultra-accommodative monetary policy implemented by the ECB.

In the US, earnings have recovered from their low levels of the post 2008 crisis period and are probably caught in a difficult position with the prospects of a recession in 2019 and thus only little upside potential.

While we are not in the business of forecasting recessions, we conclude that earnings for US companies are probably much closer to peak levels than the ones of their European counterparts. The US market has furthermore been pushed by the corporates themselves through extensive use of share buybacks and M&A activity. The picture is different in Europe which is now progressively coming out of long period of earnings deflation and should now be, off a current low base, able to benefit from an improving macroeconomic context.

Exhibit 4: US/Europe at different stages of the earnings cycle.
100=01/10/2007. 12 month trailing earnings. Eurozone earnings started in May 1998.
Source: MSCI, Datastream, SG Cross Asset Research/Equity strategy.

To sum up

The European macroeconomic outlook is mixed with credible signs of improvement on the economic side but still important (geo)political risks that might put some negative pressures.

Our belief is that those short-term risks, while affecting the operating environment of the companies, will only have a limited impact on the long-term prospects of the earning power of the companies we invest in and hence on their stock price. On top of that, the European Equity market is supported by reasonable valuations and a positive earnings outlook. Overall it creates an environment where the increased volatility generates investment opportunities for us as long-term investors.

Chinese companies have been buying on average one European company a day since the beginning of the year demonstrating the real attractivity of European companies.

For the reasons described above, we are also finding new interesting investment opportunities like the recent additions in Duerr and Marks & Spencer show. We strongly believe these companies show the two essential ingredients of a successful investment case: strong earnings power and low valuation.