The case for Europe – myths vs reality

As the longest US bull market in history is nearing its 10th anniversary, more and more investors are starting to take a serious look at international markets to potentially shift allocations to. Over the summer we met with a series of US investors to discuss why we believe the current opportunity in European equities is uniquely compelling. While on the one hand we're seeing unprecedented interest in our strategies, we realize that many misperceptions still linger about Europe. Our goal for this piece is to recap our recent conversations and highlight why we think ***the outlook for European equities is the brightest it has been in over a decade.***

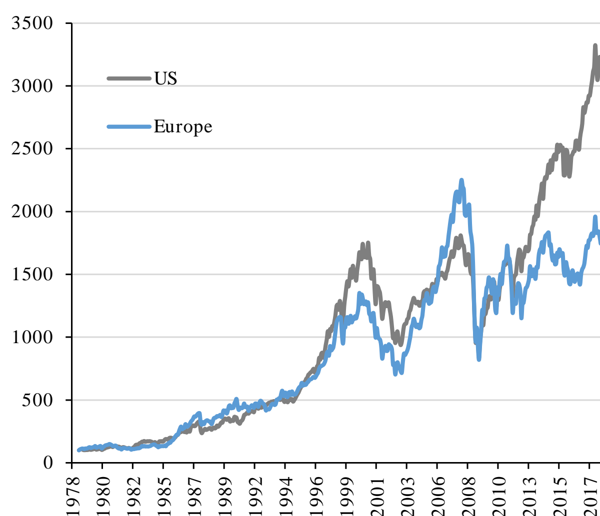
Why Europe now?

- Current stretch of European underperformance is unprecedented both in length and magnitude
- Earnings recovery is coming back very strongly and Europe's operational leverage is vastly underappreciated
- Discount to the US has never been this wide (39% vs 24% average)
- Macro data is still near two decade highs and indicates robust economic growth
- CAPEX boom expected: Europe running close to peak capacity
- Support for the euro remains very strong and it's actually increasing in Italy
- Significant outflows from the region tend to be a good contrarian indicator
- Small cap remains the best way to benefit from Europe's recovery

Myth: Europe always underperforms the US
Reality: Not true historically and the current stretch of underperformance is unprecedented

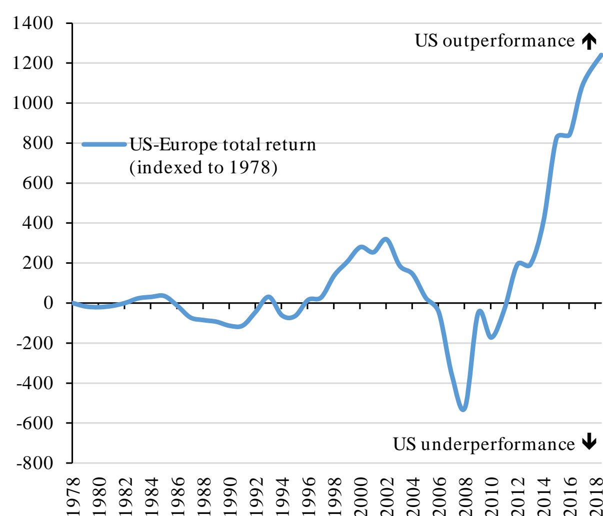
- Europe and the US have moved in lockstep for decades and the stretch of significant European underperformance since the 2008 financial crisis is highly atypical.
- However, even if we include the crisis, in dollar terms **European equities outperformed the S&P 500 in 8 out of the last 15 calendar years**.
- Over the long term, during years of outperformance Europe is on average 13% ahead of the US.

Longest stretch of European underperformance



Source: SWMC, Datastream

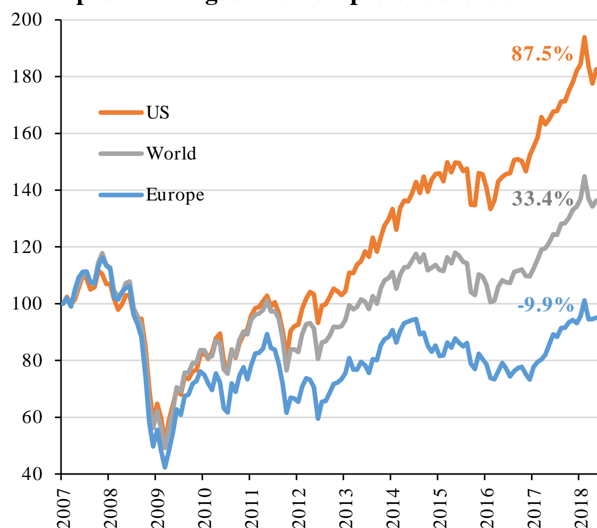
Divergence in performance started post-crisis



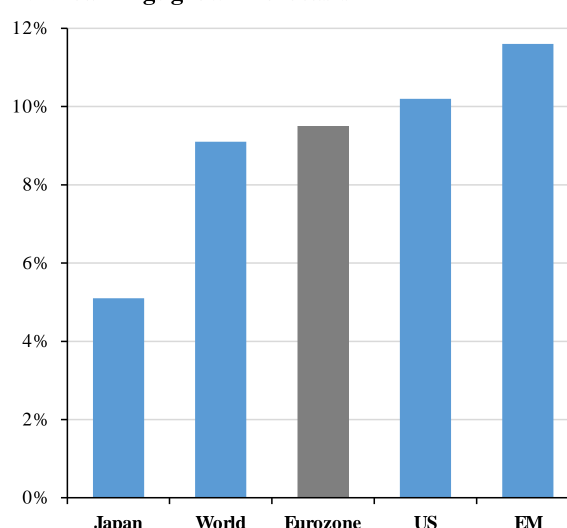
Source: SWMC, Datastream

Myth: European earnings are not growing as fast as the rest of the world
Reality: No longer true and the operational leverage of the region remains underappreciated

- The earnings argument is valid, but backward looking. We believe that the single biggest reason for Europe's post-crisis underperformance relative to the US has been the lack of earnings recovery.
- From the bottom of the crisis (March 2009), US equities returned 290%, whereas Europe is only up 115%. During the same time European earnings doubled, but US earnings almost quadrupled.
- **European earnings are still below pre-crisis levels**, while the US is nearly 90% higher and the rest of the world also grew 33%.
- Looking ahead, analyst consensus now expects European EPS to grow at a similar rate to the rest of the developed world, at around 10% in 2019.

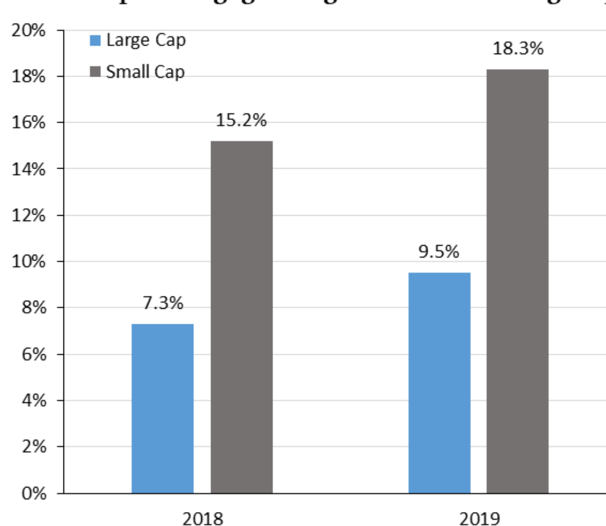


Source: SWMC, Datastream



Source: IBES, Datastream

- We think there is **significant upgrade potential to these consensus numbers**, based on what we are seeing in our own portfolio from a bottom up perspective and what macro data suggests.
- Historic data and current operational leverage implies **a 6x earnings multiplier on GDP** growth, which should result in EPS growth closer to 15%.
- Another way to benefit from strong earnings growth is to focus on **small caps** in continental Europe. This segment of the market is more nimble and has better exposure to the domestic recovery which translates into significantly faster EPS growth.



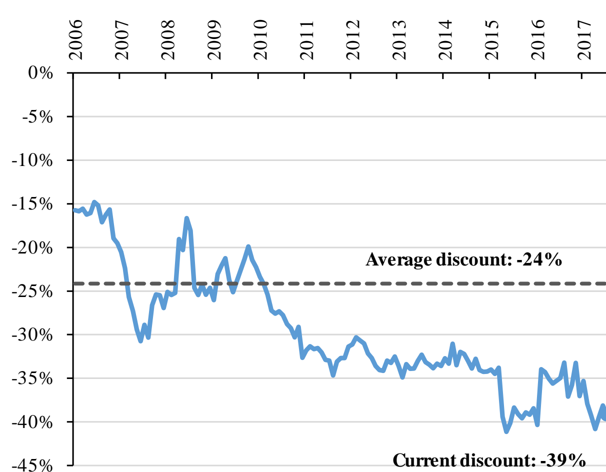
Source: SWMC, Datastream. August 1, 2018

Myth: Europe is always trading at a discount to the US

Reality: Yes, but the current discount is well above average and close to the widest on record

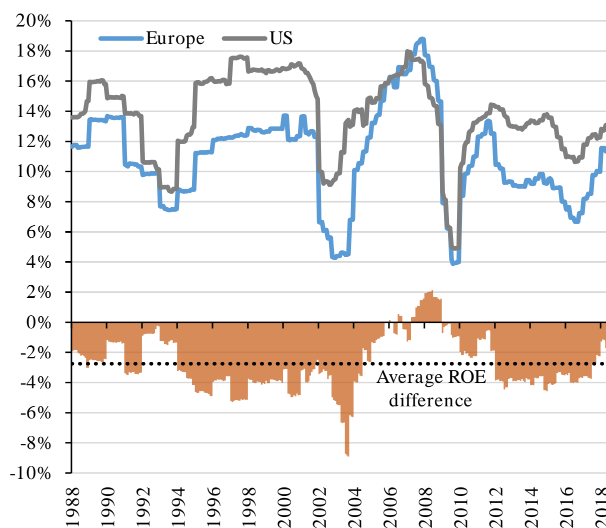
- Investors are aware that Europe is trading at a discount to the US, and the usual reaction is that the US valuation premium is justified given higher growth, higher margins and better return on equity.
- While we agree that some discount to the US is warranted, we are finding it very hard to explain why **Europe is trading close to the deepest historic discount**, while earnings are expected to grow at the same pace as the US and the margin and ROE gaps are actually narrower than their long-term averages.
- We believe that as soon as operational leverage starts showing in Europe next year, a significant valuation rerating can take place.
- A rerating to the average historic discount alone would offer 50% upside from current levels.

How cheap is Europe relative to the US?



Source: Thomson Reuters, Datastream, SWMC. June 1, 2018.
Notes: relative valuation across P/E, P/B, EV/EBITDA, EV/Sales and dividend yield

ROE discount does not explain valuation gap

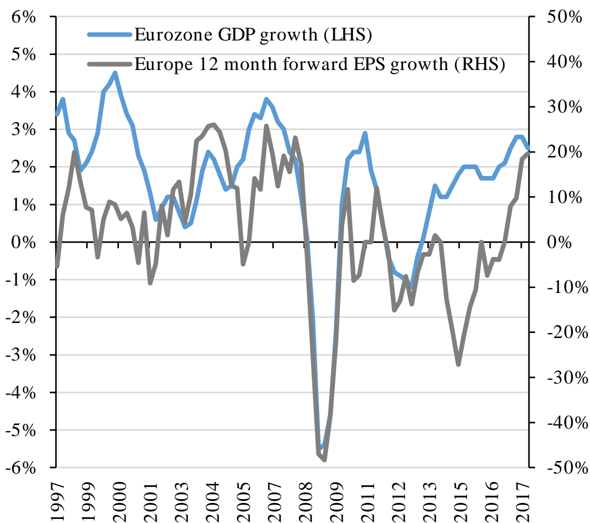


Source: SWMC, Datastream

Myth: The recovery in European economies is running out of steam
Reality: Macro data still near two decade highs and supportive of robust growth

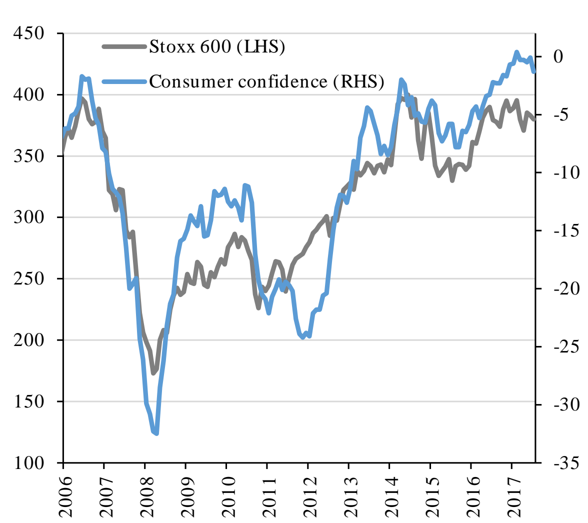
- Across both hard and soft data European macro continues to impress.
- In our view, the only thing that has slowed is the rate of change, and while growth is no longer accelerating (from a low base), the most recent readings of PMIs, retail sales, industrial production, credit growth, unemployment, and the European Commission's broader economic sentiment indicators all point to robust GDP growth for the next 24 months.
- Consumer confidence remains at a two decade high and we see no reason why the market should not rerate to a level implied by the consumer's bullish outlook.

Earnings growth follows economic momentum



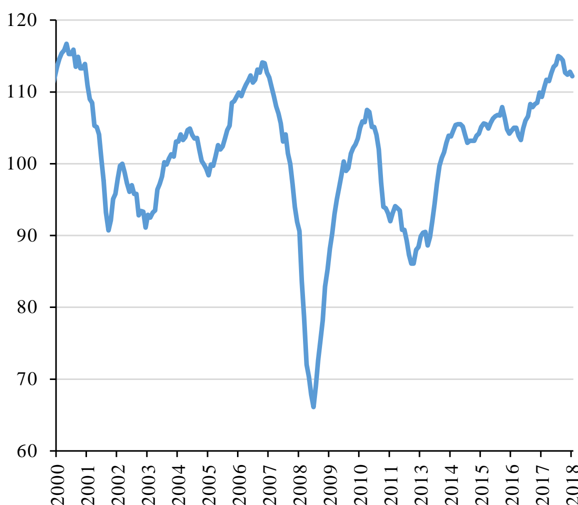
Source: Eurostat, Datastream. Q1 2018.

Consumer confidence remains robust



Source: Datastream, Eurostat

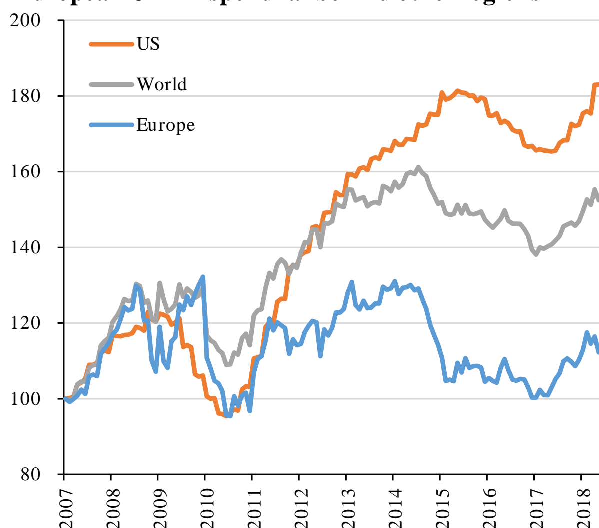
Economic sentiment close to a two decade high



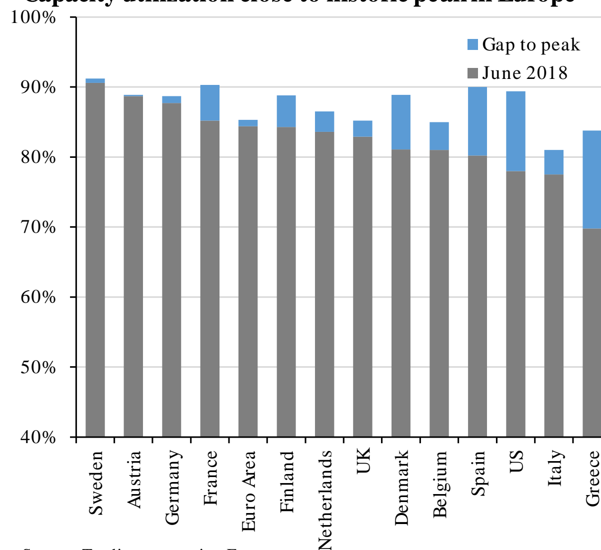
Source: European Commission. June 2018.

Myth: CAPEX remains muted – European CEOs are concerned about the outlook
Reality: Capacity utilization is nearing peak levels and there's strong pent-up demand from a decade of underinvestment

- Capital expenditure has indeed stagnated in Europe post-crisis on both an absolute and a relative basis.
- The reason we believe that spending will pick up in the next 12 months is that **many industries are now close to full capacity**. This is something we picked up on in our conversations with executives over the last year and we're now seeing it reflected in official data as well.
- Tight labor markets and increasing automation are also supportive of a CAPEX boom.
- The **pent-up demand from a decade of underinvestment** cannot be met overnight – we think we're at the beginning of a multi-year spending cycle that should add further support to the already robust economic growth on the continent.



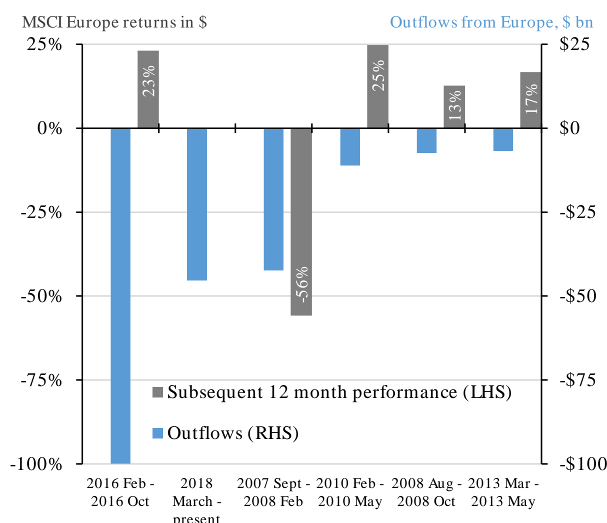
Source: SWMC, Datastream



Source: Tradingeconomics, Eurostat

Myth: Outflows are a leading indicator of poor performance
Reality: The 5 largest streaks of outflows were followed by positive returns outside 2008

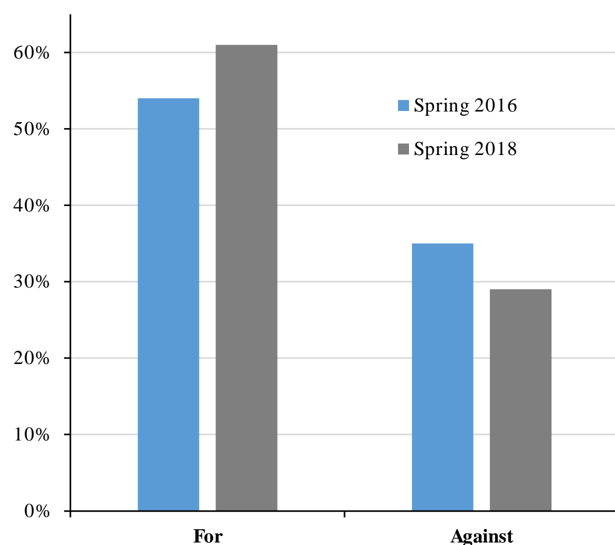
- Since March we have now seen 18 weeks of consecutive outflows from Europe, totalling $45bn.
- This is the **second largest outflow streak on record** behind 2016, when $100bn was pulled from Europe over 38 weeks.
- It is worth noting, however that outside the financial crisis in 2008, the 5 largest streaks of outflows were followed by strong positive returns over the next 12 months.
- Even on a relative basis, today's levels of outflows have subsequently seen Europe outperform by 5% on a six month view.



Source: Goldman Sachs, Datastream, SWMC

Myth: Italy is on the verge of leaving the euro and causing the collapse of the currency union
Reality: Support for the euro has increased in Italy and there's room for macro surprises

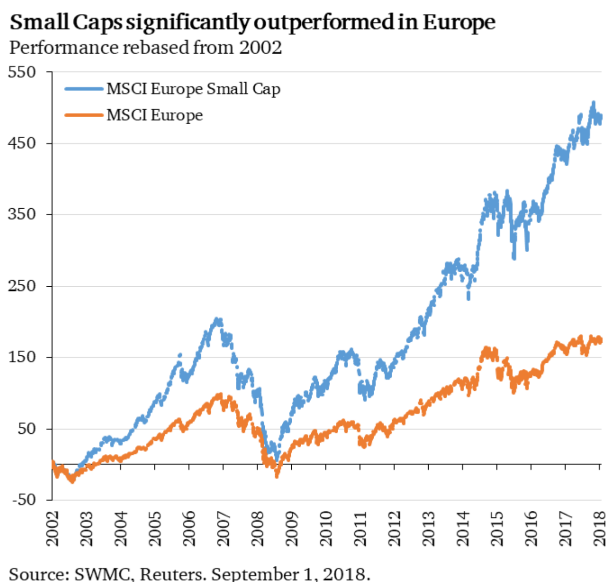
- The Italian election created significant volatility over the last few months as the market struggled to understand the implications of a government led by the two main populist parties (Five Star Movement and Northern League).
- We closely monitored the evolution of the Italian coalition's economic and political priorities and were pleased to see that many of the more extreme policies that each party included in early manifestos - such as a referendum on the euro - have been abandoned.
- In our view, the shift from such a polarizing idea made perfect sense, as **the majority of Italians is in favor of the euro and the monetary union**. In fact, support for the common currency has strengthened over the last few years.
- Italians also understand that their own savings, overwhelmingly held in euro denominated debt products, would be at huge risk should they abandon the common currency. Such a risk was never part of the Brexit referendum.
- We believe that the populist shift in Italy does not present real systemic risk, and some of the more unorthodox proposals of the government could even offer a much needed boost to the stagnant Italian economy.
- The core features of the government's program are tax cuts and a universal income for Italy's poorest households, both of which have the potential to lift Italian economic activity in the near term.



Myth: Large multinationals are the best way to play Europe

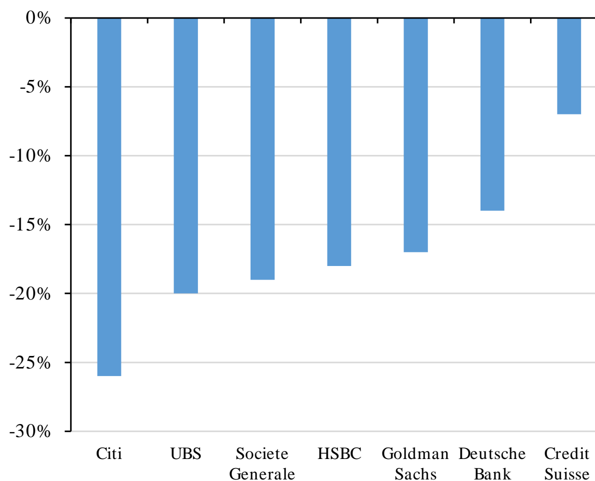
Reality: Small cap has consistently outperformed and the opportunity to generate alpha is getting even better

- We often hear from US investors that their preferred way to invest in Europe is to focus on large, stable multinational companies that generate most of their revenues outside the continent. The rationale is that these companies are not linked to the anaemic performance of the European economy and benefit from global demand.
- Companies like Nestle or Unilever were also seen as safe haven bond proxies during an environment where investors were starved for yield.
- While this approach was sensible during a European downturn, **it fails to capture the current robust economic rebound** and adds unwanted exposure to the recent Emerging Markets turmoil.
- We believe that smaller, more entrepreneurial companies that are geared to benefit from a domestic uptick in the European economy are much better positioned at this stage of the cycle.
- Historically, **small caps have shown consistent outperformance relative to larger European companies**.



Source: SWMC, Reuters. September 1, 2018.

- In our view, European small caps will continue to outperform, as indicated by their significantly faster earnings growth, and we are also confident that **in the post-MiFID world the opportunity to generate substantial alpha has only increased**.
- While the unbundling of research has only started a few months ago, we are already seeing a sharp decline in sell side research coverage within the European small cap universe.
- This is a **huge tailwind** for our bottom-up stock picking process that's centered on rigorous on-the-ground research and independent thinking.



Source: Kepler Cheuvreux. August 28, 2018.

Key takeaways: *As the US enters its late cycle phase, it's time to take a close look at Europe*

- Current stretch of European underperformance is unprecedented both in length and magnitude. The US outperformed by 175% since the bottom of the crisis but Europe is now well positioned for an overdue catch-up.
- Earnings recovery is coming back very strongly and Europe's operational leverage is vastly underappreciated.
- There is always a valuation discount to the US, but it has never been this wide (39% vs 24% average) and we struggle to see what justifies it.
- Macro data is still near two decade highs and indicates robust economic growth
- CAPEX boom expected: Europe running close to peak capacity after a decade of underinvestment.
- Support for the euro remains very strong and it's actually increasing in Italy. Politics is mostly noise: we focus on the business cycle, earnings and valuations, all of which are positive.
- Significant outflows from the region tend to be a good contrarian indicator.
- Small cap European stocks have consistently outperformed their larger peers and the opportunity to generate alpha has improved even further due to recent regulations.

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