Tide is turning

Market should see the start of a multi-year trend of European equity outperformance

By Jason Tannen and Colin Graham

EUROPEAN equities have so far risen by 11 per cent in local terms for the year through April. After seven years of significant underperformance compared to US equities, European equities have outperformed by 8 per cent in local terms to April. It is not too late to participate in what we think should be a multi-year trend of European equity outperformance.

European equity valuations remain cheaper than US equity valuations. On a Shiller (cyclically adjusted price-earnings ratio), Europe still trades at a high 30 per cent discount to US equities. Many investors have suggested that a high premium remains valid because investors are willing to pay for growth and we have seen more profit growth in the US.

While US profitability growth has been steadily positive for the past five years and US corporate margins have risen above their pre-financial crisis highs, European profitability has been shrinking and margins remain relatively depressed. Even Japanese corporate margins have surpassed their pre-financial crisis highs of 2007.

Boosted by several different factors which have come together over the past year, we think the tides are changing for European corporates. Our opinion is that in 2015, European profit growth will surprise to the upside and help to unlock much of this relative value for European equities.

Outlook for European corporations

The outlook for European corporates is positive; after years of stagnation and dealing with two large crises (the financial crisis in 2008/2009 and the euro sovereign crisis in 2010/2011), European corporates are well placed to benefit both from a cyclical economic recovery as well as the hard decisions taken by governments (over the past five years). Hard policy decisions were taken to lower the risk of future banking crises and limit the systemic impacts of the next downturn – government fiscal cutting and bank balance sheet deleveraging being the most notable.

We expect higher cyclical economic growth for Europe and the world over the coming year. Financial conditions for Europe have improved significantly over the past 12 months. First of all, the European economy will continue to be boosted by the recent fall in oil prices as Europe is a significant net oil importing region.

Secondly, European exports should be supported by the significant depreciation in the currency (the euro has lost about 27 per cent of its value versus the US dollar over the past 12 months).

Thirdly, while cuts in public spending continue, the deepest of them were undertaken in Europe in 2011, 2012 and 2013. The reduction in these cuts is alleviating the impact on the private sector. In the face of the eurozone sovereign crisis in 2010, many governments across Europe chose to cut their spending significantly to improve their fiscal budget balances. Fiscal prudence is still helping to put the European economy and financial systems on a more sustainable path for the future.

Finally, the European Central Bank's (ECB) actions, having firstly initiated negative deposit rates and subsequently (in January 2015) a full-scale asset purchasing programme (quantitative easing), have helped to dramatically lower the cost of finance for corporations across Europe. These policy measures have been enacted to accelerate the easing of financial conditions across the eurozone. This was necessary to improve access to credit for consumers and other small corporates that have been struggling to obtain financing over the past seven years.

After shrinking for the past five years, we now expect lending growth in Europe in the coming years. Bank lending growth has been hindered by the structural overhaul of the banking system, which was forced upon the banks in the aftermath of the 2008/2009 financial crisis. Governments and regulators have been forcing banks to raise higher buffers of capitals and to deleverage their balanced sheets to ensure that they are better able to withstand future financial shocks and to avoid such shocks having wider systemic impact on the economy.

This process has taken a long time and caused a large drag on European bank lending over the past few years. While the banks still have some work to do, the bulk of it is behind them and the ECB's comprehensive asset quality review in late 2014 has given banks the green light to start lending once more. In recent years, the unwillingness of banks to lend has stalled tentative recoveries. Now, with consumer and business confidence on the rise, consumption and investment can occur and be aided (rather than hampered) by lending if required.

These reasons make us positive on the near-term and longer-term outlook for European corporate profit growth after years of disappointment.

Risks

Key risks to this positive European outlook include the possibility of "Grexit" (Greece exiting the euro area) and/or deflationary fears destabilising the economy.

While the risk of Grexit has been rising in recent months, we do not believe this provides the same systemic risk to the eurozone as it did in 2010. We believe that the European economy is now in a more developed state compared to where it was in 2010 and 2011. The actions and steps undertaken by the ECB and other parties should protect the eurozone more if Grexit occurred today than if it had occurred in 2010 or 2011. If Grexit were to occur, the equity market would no doubt sell off, but we would see that as a great buying opportunity, rather than something more sinister.

Fears of deflation are valid given Japan's experience (over the past 25 years). In Japan, a deflationary spiral materialised and goods prices fell for over a decade. This delayed business investment and consumption as companies and households saved their money (anticipating cheaper investments and goods in the future). Today, European consumer and business confidence surveys have continued to rise – this suggests that they are looking through the headline deflation data (and the Grexit fears) and are willing to consume and invest more. The establishment of a deflationary mind-set (and impacting economic activity) would be a risk, but not one we are concerned about today.

Opportunities

As described above, there are several positive drivers coming together that will benefit European equities today, favouring both European corporates that focus their businesses predominantly on their domestic markets and those that have a broader and more international focus.

While European large cap equities will benefit from this cyclical recovery, we also see good opportunities in domestic European growth focused companies. Hence our positive view on European small caps due to their higher domestic revenue exposure. In early 2014, MSCI Europe's reported revenue exposure to Europe was 55 per cent, while MSCI European small caps amounted to 70 per cent. W

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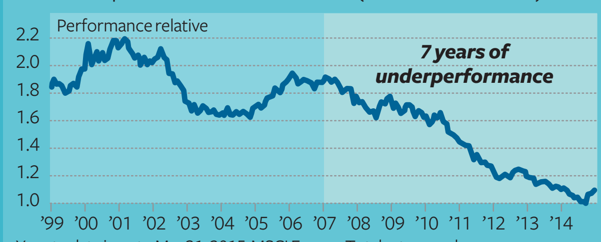
Relative performance

MSCI Europe vs MSCI USA local terms (rebased Dec 31, '14)

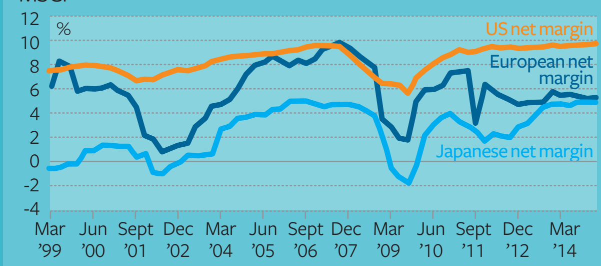


Year to date is up to Mar 31, 2015. MSCI Europe Total return and MSCI USA Total return in local currency

Source: MSCI, Bloomberg

Net profit margins

MSCI



Source: MSCI, Bloomberg

Bank lending growth

Source: ECB, Datastream