Investment Perspectives

European Equities: Late to the recovery, but primed to outperform

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Article Highlights:

- Recent economic data out of Europe suggest that stocks of Euro-centric companies—those with the majority of sales derived from Europe-- may outperform their U.S. and Asian counterparts over the next two to five years.
- Europe's economy is showing signs of growth, and will get help from continuing monetary stimulus, lower oil prices and a relatively weak euro.
- Sectors sensitive to the business cycle stand to benefit the most from the turn in the regional economy, while defensive sectors such as consumer staples will likely fall out of favor.
- Risks to the outlook include high unemployment, weak corporate profit margins, potential that Greece will leave the currency union, and that tensions between Ukraine and Russia could spill over into Europe.

A world apart

Over the past five years, Europe's economy has struggled to grow amid weak consumer demand, slowing growth in Asian export markets, a relatively strong euro, rigid labor market regulations, and an internal sovereign debt crisis that led to bailouts of four different countries. These weak conditions resulted in the first region-wide general decline in consumer prices (i.e., deflation) since at least 1997. At the same time, tensions continue to simmer in eastern Ukraine, and the potential still exists for Greece to leave the Eurozone in order to resolve its debt situation.

Despite these challenges, the Eurozone remains the largest economic block in the world, and now economic "green shoots" are emerging across much of the Eurozone, signaling the earliest stages of a recovery. Auto sales are picking up, heavy duty truck registrations are on the upswing, mortgage applications are starting to rise again (sharply improving in Italy and Germany), and consumer confidence is on the upswing. Households, particularly in the U.K., have begun deleveraging following the recessions, and political leaders are making some progress in pursuing economic reforms necessary to improve their competitiveness. For example, the automotive unions in Spain renegotiated

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contracts with auto OEM's and now they are some of the most cost competitive in Europe.

What's more, the European Central Bank (ECB) is encouraging growth with a quantitative easing program. In January the ECB announced a €60bn-a-month bond-buying program that was far larger than investors had expected. ECB president Mario Draghi said the bank would buy more than €1tn in assets, including government and private sector bonds by September next year. In response, already low interest rates fell further, and the euro has weakened significantly against the dollar since the middle of 2014, boosting the competitiveness of European exporters. Meanwhile, lower oil prices will reduce energy costs and should encourage more consumer spending.

As the rebound takes hold and growth begins to accelerate, European stocks are poised to benefit, as the combination of an improving macroeconomic outlook and low valuations offers a potentially more favorable investing climate than exists either in the U.S. or Asia.

Comparing valuations

A lack of economic growth and a weak pricing environment have left European stocks trading at comparatively low valuations. Stocks in Europe are currently priced at about 15-times forward earnings, which are projected to grow by about 10 percent in 2015. That compares with about 17-times earnings for the S&P 500, where earnings are growing at about 5 percent, and 13-times earnings in Asia, where profits are also expanding at a strong 11 percent annual rate. Meanwhile, Chinese stocks have surged in 2015, with the Shanghai Stock Market trading at 19-times earnings, a five-year high.

European price/earnings (P/E) multiples have been somewhat inflated by the lack of profit growth in Europe over the past five years, and now reflect a level of profitability that is well below normal. As the European economy begins to rebound and profits grow, share prices can rise without pushing valuations sharply higher.

Valuations in Asia look the most attractive on a relative basis, but growth in the region is decidedly slowing as China's economy cools down. It may take decades for the region to grow into all of the industrial capacity and infrastructure that has been added in China and other parts of the region. The transition from an investment-driven economy to one based on internal consumer demand is not an easy one, and growth may not pick up until that process is complete. By contrast, Europe offers the potential for a more imminent economic rebound.

Meanwhile, in the U.S., the Federal Reserve's aggressive moves in the aftermath of the financial crisis have led to a modest but persistent recovery and has driven up equity valuations. With the Fed's quantitative easing (QE) program now over and interest rates likely to begin rising in 2015, the money that has poured into U.S. stocks may go looking for a new home.

Exhibit 1

European stocks lagged U.S. and world stocks since 2009

Source: Haver Analytics, data is daily as of May 6, 2015

Exhibit 2

European stocks have outperformed global and U.S. this year

Source: Haver Analytics, daily data as of May 6, 2015

Europe is also still dealing with a host of issues. Greece's difficult negotiations with creditors is making a default a greater possibility, which injects a level of uncertainty into the eurozone's future and undermines confidence. Following election gains by anti-austerity parties in Greece, populist movements in other countries such as Spain could gain traction and hinder labor market reforms, inhibiting the region's long-term growth prospects, and tensions between Ukraine and Russia could spill over into Europe by curbing trade and spooking investors concerned about the conflict's impact on the region's economy. But these concerns, while legitimate, may be obscuring the upside potential of European equities as conditions normalize.

Europe: The upside play

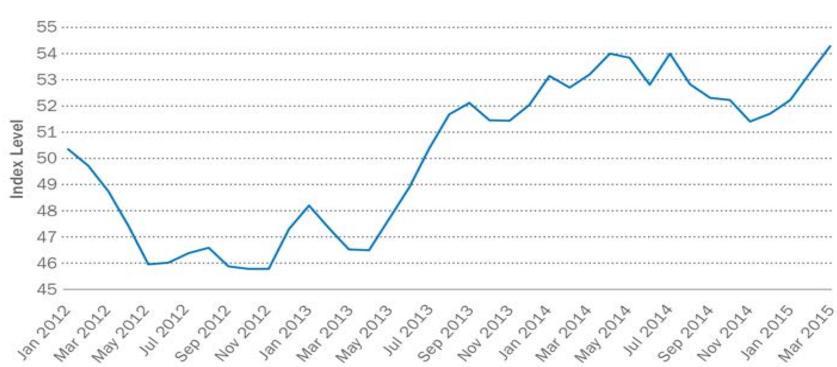
European stocks have rallied significantly since the start of the year, far outperforming the U.S. and other parts of the world. Indeed, some investors have even begun to wonder if valuations have gotten too rich. But we believe there is more upside in Europe and that a number of factors point toward higher earnings potential – and thus valuations – going forward.

First, monetary stimulus from the ECB – in the form of an aggressive QE bond-buying program – is just beginning. The ECB plans to run the program for at least 18 months so that it can be sure inflation in the region has stabilized. The bond purchases, which began on March 9, could help strengthen consumer demand, increase capacity utilization, and support the growth of credit. Essentially, Europe is now where the U.S. was at the start of its own QE in late 2008. We believe the outcome will be similar, with stocks getting an immediate boost, interest rates falling, and consumer confidence reviving.

As European QE gets under way, economic activity appears to be heating up across the region. The Markit Purchasing Managers' Index, perhaps the most widely followed regional indicator after GDP growth and inflation, rose to a ten-month high in March. This confirms anecdotal evidence from leaders of industrial corporations that orders are starting to reflect an increased level of optimism among businesses, which have begun to build inventories in anticipation of steadier demand.

Exhibit 3

Eurozone composite PMI 2011–2015



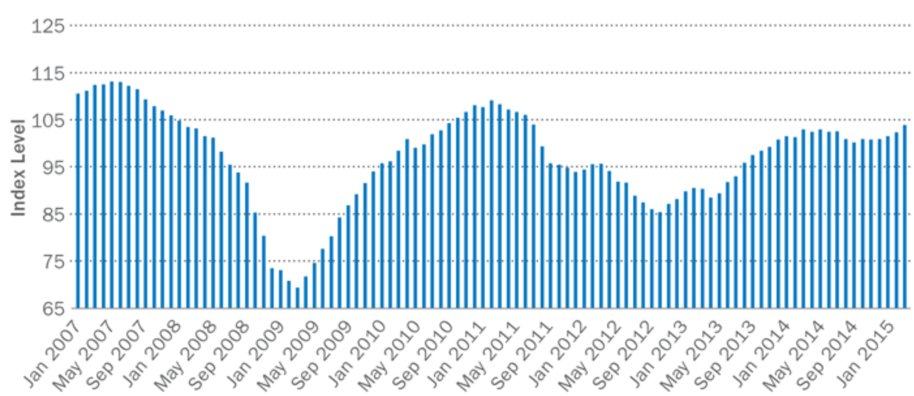
Source: European Commission

Among other recent green shoots, auto registrations rose in 2014 after six years of declines. Even more telling is the type of auto sales: While luxury car sales have held up relatively well, more economical models are down 30% from their peak. Now, they are starting to pick up, especially in the austerity and Eastern European countries where growth has been weakest. These are the types of cars sold to people who have recently returned to the work force, a sign that conditions are improving.

One of the biggest problems for European businesses has been weak consumer demand, caused in large part by high levels of unemployment. That should change in the future, however. Already, unemployment levels in Spain, Ireland, and Portugal have started to decline from their peak levels seen in 2012 and 2013. While unemployment rates in Italy and France are still nearer peak levels, they should start trending lower as the effects of QE kick in. Also, even during the current economic slump, household debt in most European countries is well below that in the U.S., meaning that as new jobs are created, consumer spending should pick up relatively quickly.

Exhibit 4

Euro area consumer sentiment, 2007–2015



Source: European Commission

Finally, the weakening of the euro is helping the continent's multinational companies sell more goods and services abroad. The euro fell from 1.39 to the dollar in the spring of 2014 to a low of 1.04 to the dollar in the first quarter of 2015. By mid-May the euro had moved higher to 1.14. Even so, by some estimates, foreign exchange movements have added 3 to 4 percentage points to year-over-year revenue growth in Europe's export-dependent companies.

In aggregate, these trends suggest that Europe's economy is primed to improve, aiding European companies that slashed costs in recent years and stand to benefit greatly if demand picks up in earnest. With valuations currently low, investors are getting paid to take risks in Europe in anticipation of an economic rebound. Once growth takes root, corporate earnings are likely to increase and provide fresh support for stock gains.

Accordingly, we believe European equities currently offer greater upside potential than their U.S. or Asian counterparts. Investors are paying a lower valuation for what will likely be stronger earnings growth, compared to a situation in the U.S. where P/E multiples are now quite high and the recovery has mostly played out, and an environment in Asia in which valuations may be attractive but earnings growth is slowing.

Cyclical sectors stand to benefit the most

A rebound in Europe's economy over the next two to five years will likely have the greatest benefit for companies that operate in the most economically sensitive sectors. These range from retail industries that rely on discretionary income – automotive, hospitality, luxury goods, cruise lines – to those that manufacture capital equipment, construction materials, and other commercial infrastructure. These companies have been operating at historically depressed levels of demand, and their share prices reflect that.

In fact, the earning of many of Europe's economically sensitive businesses are still at 2008/09 levels, when the recession started. These companies have been cutting costs and moving manufacturing into lower cost geographies during this period of stagnation and are now poised for a meaningful jump in earnings per share when the European economy starts to gather steam.

The automotive industry, in particular, deserves special attention given the first rise in vehicle registrations in six years. Since the financial crisis began, Europe's biggest carmakers have cut capacity by about one million units per year, mostly in the small car segment. By some estimates, the European demand is now two million units below a normal run rate, and reduced production capacity provides ample scope for profits to flow more quickly once demand picks up. Potential buyers also have room to borrow to fund vehicle purchases given loosening credit standards and the declining consumer debt loads witnessed across the continent's major markets. In addition, some of Europe's biggest automakers derive a hefty portion of their sales from overseas markets and have already benefited from the euro's favorable exchange rate. Therefore, the macroeconomic background is very supportive of increased auto demand.

The construction sector is even further behind the automotive cycle. Across the region, construction firms are still experiencing lackluster demand. Still, history shows that residential construction typically lags the automotive market by about a year. Based on recent gains in an ECB mortgage loan survey and anecdotal evidence of improving demand from the makers of construction materials, construction activity appears primed to accelerate up over the coming 12-month period after a possibly difficult first half of the year.

It is worth noting that financial services companies normally would be the beneficiaries of an economic rebound. However they are in the process of transitioning to a new regulatory environment, which could have a negative impact on their returns. In addition, industries that tend to fare better during economic downturns – consumer staples, food and beverage companies, defense/aerospace, to name a few – will likely face pressure as investors shift their focus back to growth-oriented businesses.

Risks to the outlook

It is worth pointing out that despite a number of promising signals, the economic rebound in Europe has still not started in earnest. Unemployment levels are still historically high, consumers are cautious, and corporate margins are under pressure. If the ECB's monetary stimulus does not succeed in reversing those conditions, the region's recovery may stall. There is still a possibility that Greece will become the first Eurozone member to leave the currency union, and that anti-austerity political parties could gain traction in other countries as well. Finally, tensions between Ukraine and Russia could spill over into Europe, potentially curbing trade and fueling investor concerns about the conflict's impact on the region's economy.

European equities: keeping a long-term perspective

There are mounting signs that Europe is entering a period of economic strengthening. The ECB's recently introduced QE program appears likely to bolster consumer and business demand and support the growth of credit, leading to improved activity in the broader economy.

Investors have clearly started to notice, with money flowing into European stocks. As with other turning points, the improving economic landscape in Europe is not without risks, and it is helpful to maintain a long-term perspective regarding these events. Keeping a broadly diversified portfolio, with international equity exposure appropriate to a client's risk tolerance, offers the opportunity to generate potentially attractive returns while minimizing volatility.

For more information on how European equities can play a role in a diversified portfolio, contact TIAA-CREF.