TIAA GLOBAL ASSET MANAGEMENT

European equities: Late to recover, but primed to outperform

Chris Semenuk
Portfolio Manager,
TIAA-CREF International Equity Fund

Christian Frenes
Equity Analyst

Eugene Kim
Equity Analyst

Executive summary

- Improving economic data, rising corporate earnings and recapitalized balance sheets suggest that European stocks may outperform their U.S. and Asian counterparts over the next two to five years.
- European stocks are historically undervalued relative to U.S. stocks, particularly in the more cyclical consumer discretionary and industrials sectors.
- 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, which have been trading at very high valuations, will likely fall out of favor.
- Europe's economy continues to show signs of growth, and will get help from growing consumer confidence, economic reforms, lower unemployment, and domestically driven demand, in addition to a supportive central bank.
- Risks to the outlook include increased unemployment, weak corporate profit margins, and the potential for geopolitical flare-ups.

A world apart

Europe's economy has struggled to grow over the last several years 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 country bailouts. 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, political tensions continue to simmer in some pockets of Europe, fear of terrorism attacks are widespread, waves of immigration have created national headaches and the potential still exists for countries to leave the Eurozone.

Despite these challenges, the Eurozone remains the largest economic bloc in the world, and economic "green shoots" have emerged across much of the Eurozone, signaling 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 progress in pursuing economic reforms necessary to improve its competitiveness.

What's more, low interest rates and a euro that has weakened significantly against the dollar since the middle of 2014, have boosted the competitiveness of European exporters. Meanwhile, lower oil prices and reduced energy costs should also 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 equity valuations offers a potentially more favorable investing climate than exists either in the U.S. or Asia.

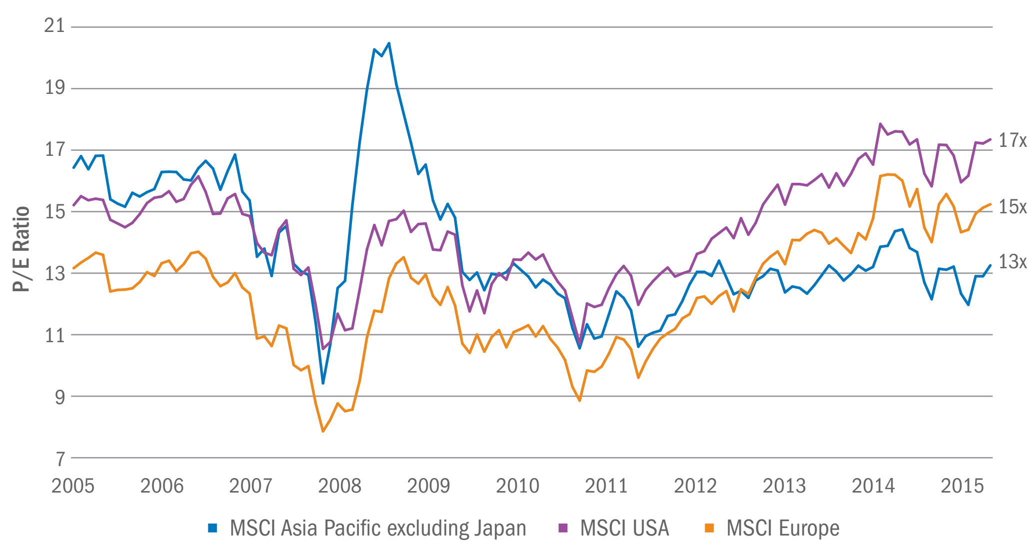
European corporate earnings are forecast to strengthen on improving economic conditions and from a weaker euro, which should in turn lead to higher share prices.

Comparing valuations

A lack of economic growth and a weak pricing environment have left European stocks trading at comparatively low valuations relative to U.S. stocks. European price/earnings (P/E) multiples reflect a level of profitability that is well below normal. As the European economy begins to rebound and profits grow, share prices may rise without pushing valuations sharply higher; European corporate earnings are forecast to strengthen on improving economic conditions and from a weaker euro, which should in turn lead to higher share prices. While conditions have been improving in Europe, equity valuations remain relatively low compared to the U.S. Exhibit 1 compares the 12-month forward price/earnings ratios for the MSCI USA and MSCI Europe indexes. Investors have been willing to pay a premium for U.S. stocks in recent years, which are viewed as a "safe haven" equity asset class relative to other regions.

Exhibit 1: European equities offer compelling relative value

12-month forward P/E ratios for MSCI USA, MSCI Asia Pacific ex Japan and MSCI Europe indexes



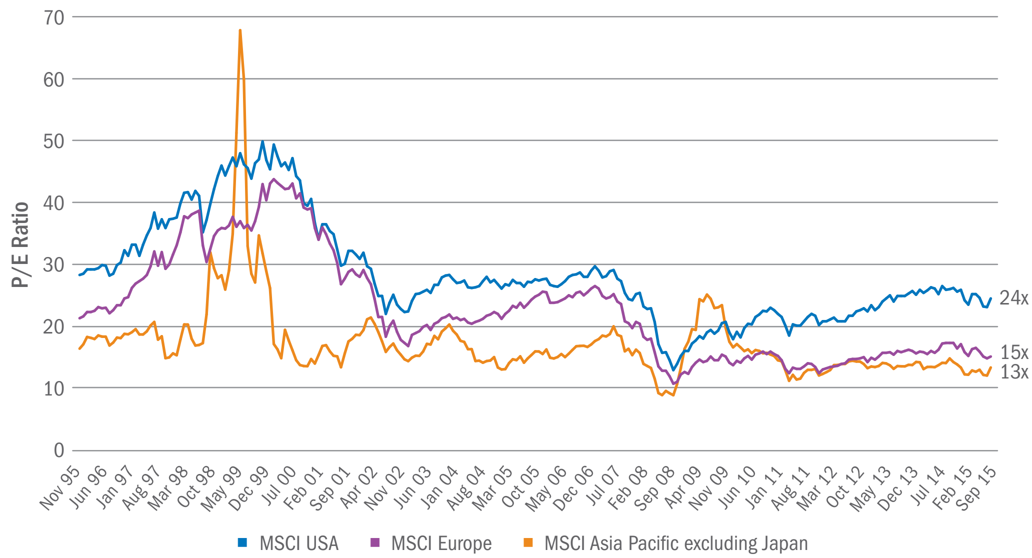
Source: Datastream, Worldscope, data as of 3/31/2016.

The divergence between European and U.S. equity valuations is at the widest point in decades.

We believe European stocks have been undervalued, and as shown in Exhibit 2, the divergence between European and U.S. equity valuations have moved to their widest point in decades, when compared on a rolling 10-year average. This leaves significant room for growth in Europe, a market that has historically trailed the U.S. across cycles, and therefore presenting a compelling opportunity for global investors.

Exhibit 2: Given its trough in earnings, Europe is even move attractive relative to the U.S.

P/E ratios using 10 years' historical EPS moving averages



Source: Thomson Reuters Datastream, data as of 3/31/2016.

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, and valuations may grind lower before recovering. 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 complicated, 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, driving up equity valuations. With the Fed's quantitative easing (QE) program over and interest rates poised to rise (albeit slowly), the money that has poured into U.S. stocks may go looking for a new home.

Likewise, Europe is also still dealing with a host of issues and a level of uncertainty remains regarding the debt situation in the eurozone's future. There are certainly issues to contend with in Europe, including the rise of anti-austerity political parties and populist movements in some countries, high-profile terrorist attacks and waves of immigration that have overwhelmed some areas. But these concerns, while legitimate, may be obscuring the upside potential of European equities as conditions normalize.

Europe: The upside play

Economic activity has steadied across the region. The Markit Purchasing Managers' Index, perhaps the most widely followed regional indicator after GDP growth and inflation, has improved, albeit sporadically and incrementally over the last few years. Anecdotal evidence from leaders of industrial corporations suggests that orders are starting to reflect an increased level of optimism among businesses, which have begun to build inventories in anticipation of steadier demand.

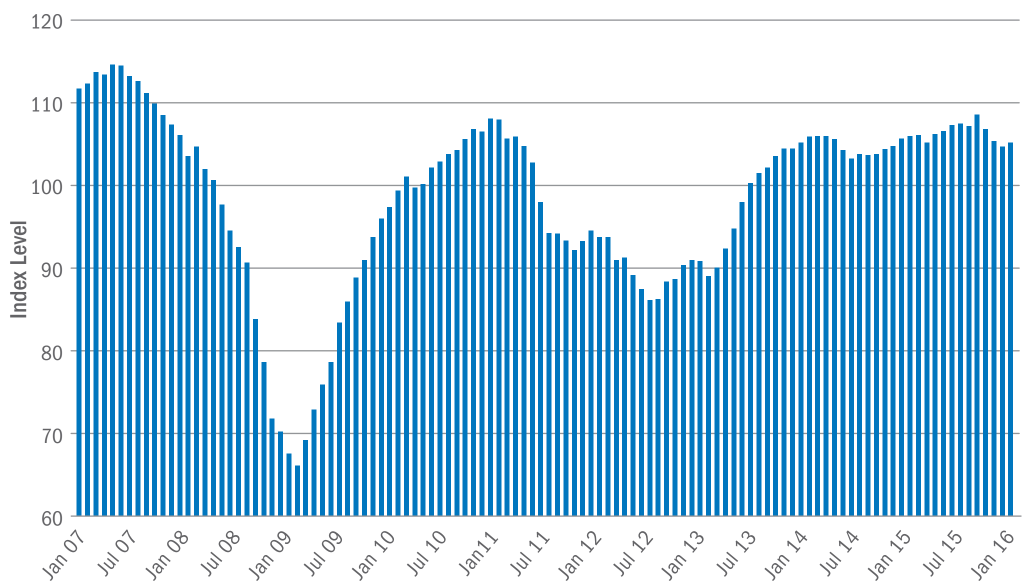
Also, monetary stimulus from the European Central Bank (ECB)—in the form of an aggressive QE bond-buying program—is a year old and still in the early stages. The ECB plans to run the program until it can be sure that inflation in the region has stabilized. The bond purchases aim to increase Europe's money supply, drive interest rates lower and support credit growth. Essentially, Europe is now where the U.S. was at the start of its own QE in late 2008 which was a multi-year event and demonstrated strong results. We believe the outcome will be similar, with stocks getting a boost, interest rates falling, and consumer confidence reviving.

Among other signs of improvement are auto registrations, which have grown significantly since 2014. 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 workforce, a sign that conditions are improving.

> 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.

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. Eurozone unemployment has hovered around multi-year lows in 2016, with jobless rates in Spain, Ireland, and Portugal declining 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. Other positive news for Europe has included rising domestic demand and economic sentiment (see Exhibit 3). This peak in domestic demand highlights that growth is coming from within the continent, and not dependent on external markets, which is important to note.

Exhibit 3: Euro area Economic Sentiment Indicator (ESI), 2007–2016



Source: European Commission

In aggregate, these trends suggest that Europe's economy is primed to improve, aiding European companies that slashed costs in recent years. 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.

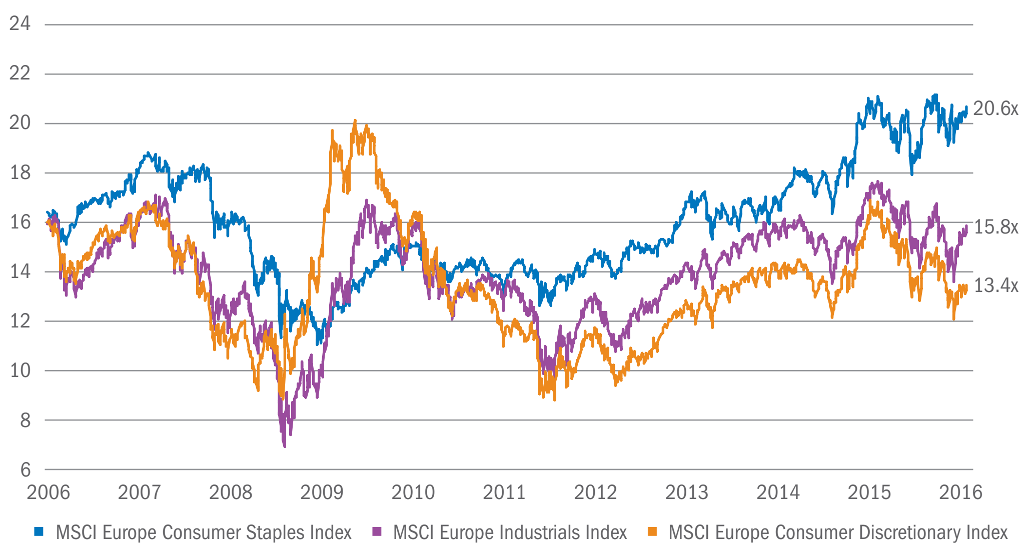
Accordingly, we believe European equities currently offer greater upside potential than their U.S. or Asian counterparts. Investors are paying a lower valuation for what will likely be stronger earnings growth, compared to a situation in the U.S. where P/E multiples are elevated and the recovery has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

Where to look within Europe: 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, while most investors in Europe have been focusing on the defensive sectors. Exhibit 4, for example, shows the price/earnings ratios of Europe's consumer discretionary, industrials and consumer staples sectors as of March 31, 2016. As shown below, valuations in the cyclical consumer discretionary and industrial sectors are extremely compelling, while the defensive consumer staples sector is at all time highs, highlighting investors "risk-off" mentality in the last several years as it pertains to investing in Europe.

Exhibit 4: Finding value among sectors in Europe

European sector P/Es: Consumer Staples vs. Industrials and Consumer Discretionary



Last data point 3/31/2016. Source: FactSet.

In fact, the earnings of many of Europe's economically sensitive businesses are still below the 2007 peaks established prior to the 2008 credit crisis, while many of their U.S. counterparts are at as much as 50% upside to their pre-recession levels. These European 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, 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 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 over the coming 12-month period after a possibly difficult first half of the year.

In the industrials sector, capital expenditures are at a 30-year low, which means companies will need to update equipment as it breaks or becomes obsolete. We have already begun to see an increase in truck orders from Volvo, which is one early sign of improvement.

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It is worth noting that financial services companies—and banks in particular—would normally 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 the early stages of recovery. Banks are additionally faced with ultra-low interest rates impeding their margins as well as flush corporate balance sheets, meaning companies are not borrowing much and lending activity is relatively low. Financial companies and banks will benefit from a stock market rally, but the sector will most likely experience a broad recovery later in the cycle, as Europe's economy further strengthens.

Finally, 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.

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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. 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 a Eurozone member will leave the currency union, and that anti- austerity political parties could gain traction. There has also been growing concern around terrorism, but while dramatically unfortunate and heartbreaking, the timing of this is random and universal around the globe, and the effects tend to be largely transitory. Finally, geopolitical tensions in peripheral regions could spill over into Europe, potentially curbing trade and fueling investor concerns about a potential 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 QE program appears likely to bolster consumer and business demand and support the growth of credit, leading to improved activity in the broader economy. Finally, all of these events are happening against the backdrop of attractive European equity valuations (on a relative and absolute level) while European corporate earnings stage a recovery. 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, but 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.

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