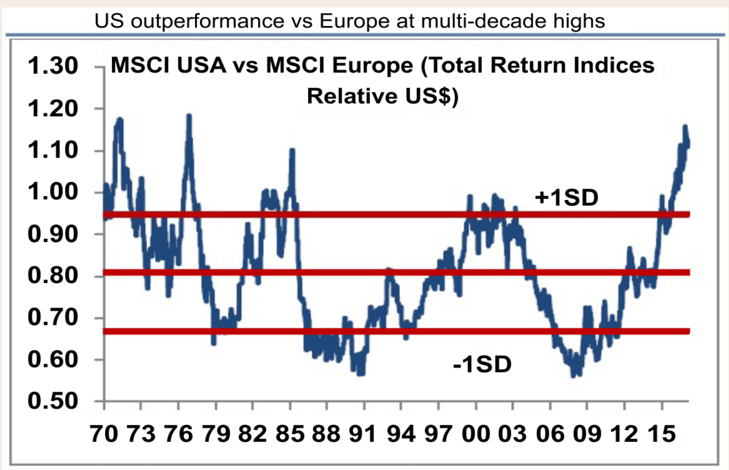
WHAT I LEARNED THIS WEEK

Excerpt from February 16, 2017

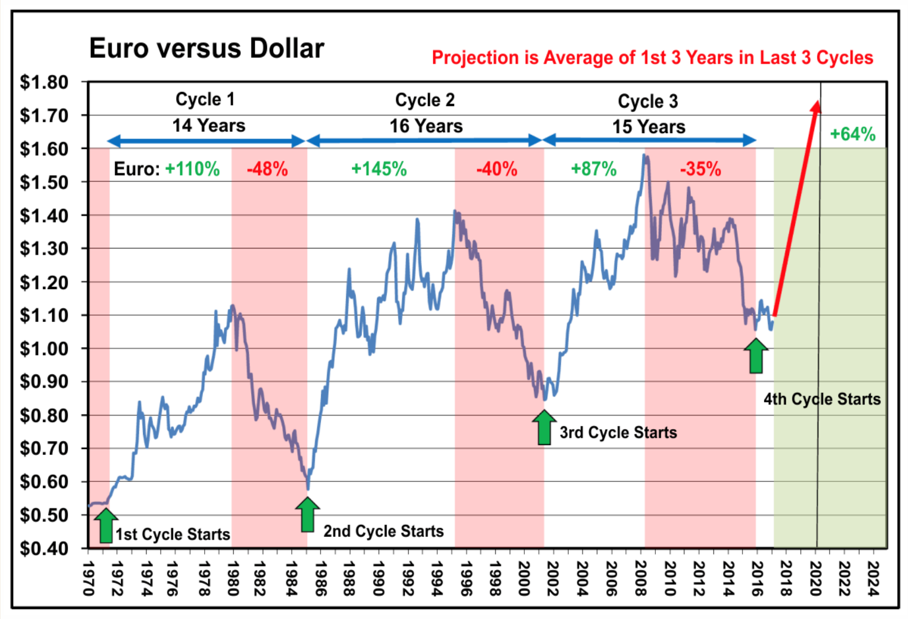
2 European equity performance is at a 40-year low relative to the U.S. Five reasons to buy European stocks.

U.S. equities have dramatically outperformed European equities since the 2008 Global Financial Crisis, with the MSCI U.S. total return index beating the MSCI Europe index by 105% in dollar terms, according to data cited by CNBC. However, as the following charts illustrate, the relative outperformance of U.S. stocks is not only near historically-peak levels, but the last three up-cycles in the euro began when the relative outperformance of U.S. equities was at more than one standard deviation above the mean (1971, 1985 and 2001, respectively). *Is the pendulum about to swing back in favor of Europe?*

As we have argued for several months, the European economy is growing faster than the U.S. Therefore interest rate differentials between the U.S. and Europe could narrow sharply. Consider the following: 1) earnings growth has turned the corner; 2) the eurozone is transitioning from deflation to inflation; 3) the banking sector is recovering and could benefit from an easing U.S. regulatory burden; 4) valuations are attractive and 5) the threat to the euro's future from nationalism is overstated.



Source: CNBC.com, BofA Merrill Lynch Global Research, Datastream, MSCI

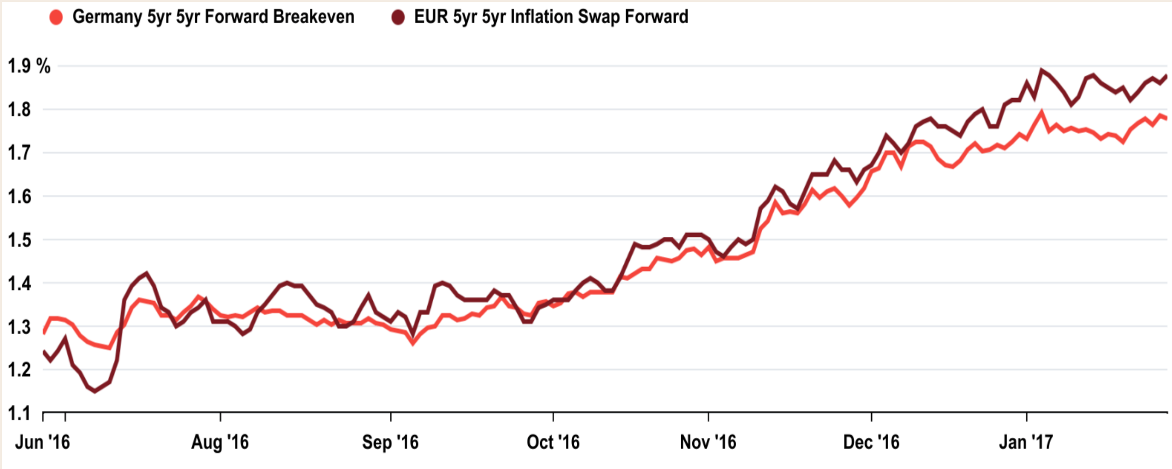


Source: A.G. Bisset Associates, LLC

- **Earnings growth has turned the corner.** About half of the companies in the Euro Stoxx 600 (371.47) have reported their financial results so far, and **earnings were up 5.05% year-over-year during last year's fourth quarter—the best performance in five years.** Nevertheless, earnings per share remain about one-third below their early 2008 peak, implying further room to increase. European companies derive about half of their earnings from outside the continent, implying that they are highly leveraged to global growth, especially in emerging markets.

  According to data provided by CNBC, BofAML estimates that *earnings growth for European companies will outpace U.S. earnings growth by 11% to 9%,* due to a recovery in commodity prices and the benefit of a weak currency.

- **Inflation expectations have accelerated since the deflation scare at the beginning of last year and are approaching 2%, although core inflation remains below 1%.** We suspect that the pressures mounting within the ECB will raise the likelihood of further tapering of the asset purchase program, sooner than currently expected.



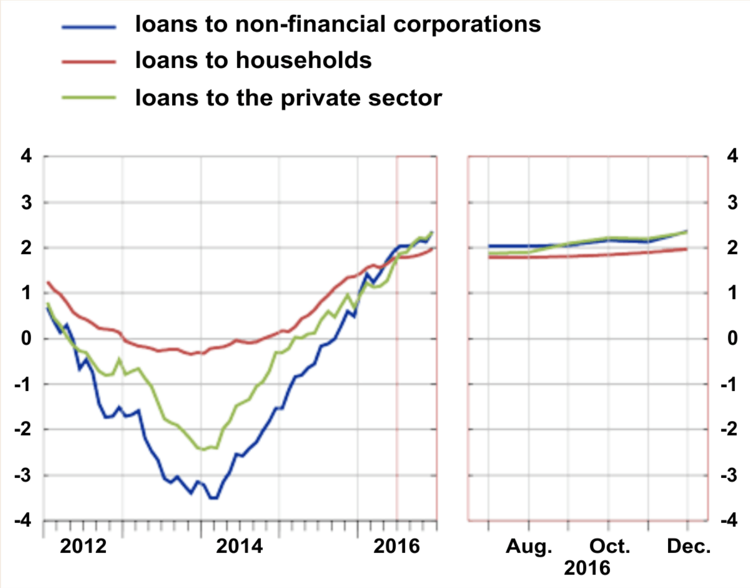
Source: Bloomberg

The eurozone banking sector is recovering. Alberto Gallo, who heads macro strategies at Algebris Investments, recently wrote the following in *The European Business Review:*

"Until now, the biggest obstacle to credit transmission was the poor health of eurozone banks, still encumbered by €1 trillion of bad loans and overblown balance sheets of around €31 trillion (which is three times the size of the economy, compared to an average of one to two times elsewhere in the world). But today **banks are on the mend, having added over €260 billion of capital since 2010**, and the ECB's plan is now starting to bear fruit. **Having signalled less rather than more purchases of bonds, the central bank steepened the long-end part of the yield curve, boosting profitability and equity valuations of banks, which borrow short term and lend long term**. The supply of loans to non-financial firms, which had been falling for several years, is now gaining pace, and had risen by 2% year-on-year in December."

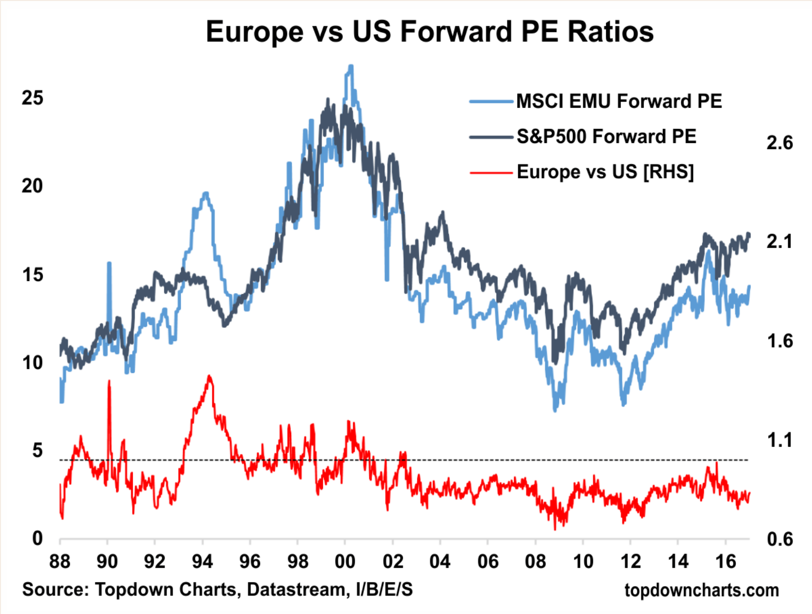
The following chart provides another snapshot of the improvement in eurozone lending growth since the 2014 bottom. As we wrote last week, **the bottom in U.S. bank lending growth occurred four years before Europe's, implying that Europe's lending recovery has considerably further to run.** Looser U.S. regulatory requirements, which would apply to European banks operating in America, are a potential bullish wild card, as well.

Eurozone adjusted loans to the private sector (year-over-year % change)



Source: ECB

- **Valuations are attractive:** European stocks trade at a 15% to 20% discount to U.S. stocks on a 12-month forward P/E basis (see following chart), and according to Bloomberg, **the gap between the price-to-book value ratio of the S&P 500 and the Stoxx 600 is at its widest level since 2003**.



- **A eurozone breakup is unlikely:** The coming French elections are often cited as a key risk to the euro, due to the popularity of the nationalist candidate, Marine Le Pen. However, according to comments by Barclays analyst, Francois Cabau, published by Bloomberg, Le Pen's National Front party "is **extremely unlikely to come remotely close to an absolute majority in the lower house** in the June general elections. She would have to accept cohabitation and thus would not be able to govern strictly following her manifesto". Furthermore, Cabau wrote: "Exiting Europe means **amending the constitution and barriers to get it done are quite high, in terms of the Parliament approval process.**"

  Although eurozone integration still has a long way to go, the common currency's **institutional safeguards are stronger** than they were when Mario Draghi gave his "do whatever it takes" pledge in the summer of 2012. Alberto Gallo elaborated: "Eurozone institutions still have plenty of dry powder, including the €500 billion-strong European Financial Stability fund. What's more, **citizens remain supportive of the European Union project, even in countries hard-hit by recessions: 73% were either positive or neutral as of mid-2016**, according to the European Commission's Eurobarometer."

  Prior investment recommendations that are leveraged to European growth include: **ManpowerGroup** (MAN, $97.15), **HeidelbergCement AG** (HEI:GR, €86.66), **Unilever** (ULVR:LN, 3,312.50 GBp), **Henkel AG** (HEN:GR, €100.11), **Gazprom** (OGZD:LI, $4.81), **ABB Ltd**. (ABBN:VX, 22.98 CHF) and **Schneider Electric** (SU:FP, €68.87).