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MARKET INSIGHT

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ARE EUROZONE EQUITIES STILL AN ATTRACTIVE PLAY?

For the past 10 years, Europe has not been popular among global equity investors. The European debt debacle and the bail-out of Greece in 2010 contributed to the long-standing negative sentiment towards "old" Europe. Low productivity, weak institutions, and a high unionization rate are also often cited as reasons why investors are weary of Europe. From an investment standpoint, this lack of interest has been justified with European equities underperforming U.S. stocks by more than 90% since the depth of the global financial crisis in 2009. This lack of financial strength was also visible in the foreign exchange market, with the Euro losing 30% against the U.S. dollar since its 2008 peak. We have observed, however, that recent sentiment towards European equities, and particularly Eurozone stocks, has dramatically changed, with global equity strategists turning overweight to the point of converting Eurozone stocks into a crowded trade.

First off, the 2015-2016 earnings recession is over, and 2017 consensus EPS growth for Eurozone equities stands at 18%, the highest among developed regions. Interestingly enough, this is only the second time in a decade that consensus EPS growth for the region has been upgraded year-to-date, contrasting with the downward revision trend that has been observed every year since 2011. One might have feared that such demanding expectations would lead to some disappointment on earnings announcement days and that corporates would miss forecasts during the earnings season. This has not been the case. Eurozone equities experienced a strong Q1 2017 that delivered the best beat in 7 years, with 20% year-on-year EPS growth and 9% year-on-year revenue growth. Plus, 61% of companies beat EPS estimates by 8%, and 80% beat sales estimates by 3%. Moreover, EPS growth was widespread, with all sectors but utilities and real estate delivering positive growth numbers. Commodities base effect helped energy and materials post the strongest earnings and sales growth, and the recent rebound in economic activity has helped to improve the profitability of cyclical companies.

Another argument boding well for Eurozone equities is valuation. Of course, on a 12-month forward PE of 15.5x, 15% above the 10-year median, Eurozone equities do not look cheap anymore. However, from a relative valuation standpoint, value gaps relative to other equity regions and other assets classes are still wide and near their crisis peaks. Our composite normalized value indicator measures Eurozone equities as being cheap relative to U.S. equities, which is further confirmed by the sector neutral relative price-to-book ratio reaching extreme discount levels. Moreover, the Eurozone dividend yield stands at 3.1%, well above the 2% U.S. dividend yield and the 2.6% yield to worst remunerating Euro high yield bond holders. From a performance perspective, Eurozone stocks are still lagging behind U.S. stocks by more than 100% in local currency since the crisis trough despite recent outperformance. Even more striking, Eurozone EPS are still 32% below the pre-crisis peak, whereas U.S. EPS are 21% above the pre-crisis peak. Measured from the crisis trough, U.S. trailing 12-months EPS have increased by 139% while Eurozone EPS have merely grown by 45%, representing a 94% growth gap. We believe that Eurozone stocks are now poised to catch up and shrink the performance and EPS growth gaps relative to U.S. equities, but also to regain traction vis à vis Euro aggregate bonds.

Overall, Eurozone economic activity has accelerated since mid-2016, and leading indicators have picked up to multi-year highs, indicating that this momentum is likely to persist. Since the beginning of the year, soft data have been particularly strong, with PMIs and confidence surveys hitting a 6-year high. Also, the Eurozone printed one of the strongest real GDP growth numbers in this past decade at 0.6% quarter-on-quarter in Q1 2017. Banks are offering cheap loans, the housing market is recovering, the labor market is tightening, and governments are promising tax cuts. The favorable resolution of political uncertainties may also unlock investments. Notably, since 2015 economic growth in the Eurozone has shifted towards domestic growth engines such as consumption and investment spending, leading to a broadening and resilient economic momentum. Lower energy prices, a weaker currency, moderately increasing inflation, and a pick-up of activity in emerging markets have all contributed to the recent growth impulse.

Cumulative fund flows into European equities were negative for most of 2016 yet started to reverse at the end of the year. Equity fund flows into Europe ex-UK year-to-date stand at $19.3bn, an increase of 7.9% and the strongest across equity regions. Most of these inflows took place right after the first round of the French presidential election, indicating that a lot of capital was on the sideline waiting for the outcome, even though the majority of global investors had turned positive on Eurozone stocks in the second half of 2016. Positioning in the region remains nonetheless low, especially after post-Brexit outflows, and we believe that inflows into Eurozone equities are likely to persist for some time since there is room to recover the capital that fled in recent years.

Despite these positive arguments, some cracks are appearing in the investment case for Eurozone equities. First of all, expected earnings growth for 2017 rely too much on the revival of financial and energy companies, with half this year's consensus EPS growth coming from these two sectors. Since mid-November 2016, year-on-year oil prices have been up, providing a tailwind to energy companies that showed in Q1 2017 numbers. However, WTI crude oil is currently down 13% year-on-year, which will again put pressure on energy companies for the rest of 2017 and put at risk the sector's 76% expected EPS growth. Bond yields in the Eurozone and U.S. are downward biased since January, as inflation expectations have been easing on both sides of the Atlantic. Should yields remain low or decline even further, this would lower banks' net interest margins and could jeopardize consensus EPS growth for the financial sector.

Secondly, economists agree that the acceleration phase of the recovery cycle is now behind us and that economic momentum in the Eurozone is likely to have peaked in H1 2017. Growth will remain steady, but forecasts are indicating a deceleration in economic momentum from H2 2017 onwards. Real wage growth remains too close to zero and financial conditions are likely to tighten going forward. Credit growth is slowing, and the outlook for investment spending is becoming clouded. Export growth seems to have peaked for now, and recent Euro strengthening does not bode well for further acceleration. Brexit negotiations and political uncertainties in Italy are potential sources of uncertainties and volatility.

No investment case has only pros and no cons, and we believe that Eurozone stocks are still an attractive play with supportive tailwinds. Strong earnings growth, attractive relative valuation, decelerating but resilient economic momentum, light investor positioning, and fading political uncertainties, have all led to a positive shift in investor sentiment towards Eurozone equities despite some clouds gathering on the horizon. From an investment perspective, the sweet spot might be found in medium-size domestic companies outside the financial and energy sector with stable growth and cash flow generation.

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