Monthly Commentary

February 2017

A better opportunity in Europe

One simple approach to investing is to ask three questions.

(1) Where are valuations?

(2) Where are fundamentals?

(3) What is it that is keeping (1) and (2) in different places?

In mid-February, with the S&P 500 up 5% year-to-date and 22% year-over-year, these are important questions for American investors to consider.

From a valuation perspective, the U.S. stock market is looking more expensive. On Friday, February 17, the S&P 500 closed at 2,351, or 17.7 times operating earnings expected by analysts over the next year. This was 11% above its 25-year average. Moreover, the forward earnings estimate upon which this is based is a lofty 24% higher than the actual operating earnings per share (EPS) achieved by S&P 500 companies last year.

Overall, U.S. fundamentals do still look promising. Economic growth is solid, profits are rising, interest rates remain low and there is the prospect of help from the federal government both in terms of less regulation and tax cuts.

However, the U.S. is now in the eighth year of an economic expansion and diminished slack in the economy should drag on earnings growth going forward. Annual real GDP growth over the next five years is unlikely to average more than 2.0% and nominal GDP growth is unlikely to exceed 5%. With interest costs and wage pressures rising, EPS are also unlikely to grow more than 5% per year from 2018 on, giving a price appreciation of 5% per year if price to earnings ratios (P/Es) were flat. However it is more reasonable to assume that P/E ratios will revert to their mean and, if this were to happen over the next five years, it would subtract 2% per year from price appreciation. Adding on a dividend yield of 2%, could boost total returns to 5%.

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A reduction in corporate taxes would, of course, add something to this. However, a recession, which more than likely will occur within this time span, would have the opposite effect. All told, because of more expensive valuations, returns of 5% per year now seem like a relatively optimistic forecast for U.S. large cap stocks over the next five years.

European stocks, by contrast, look more attractive. The current forward P/E at 15.0 times, is just 3% above its 25-year average, and analysts in Europe, while probably still a little too optimistic in forecasting an 11% 2017 earnings jump, may end up being more accurate than their U.S. counterparts. In addition, the average dividend yield on the MSCI-Europe index is 3.6% compared to 2.0% on the S&P 500.

Moreover, while the U.S. is essentially at full employment, the eurozone is still earlier in its economic expansion. The U.S. unemployment rate has fallen to 4.8% in January of this year from an October 2009 peak of 10.0%. In the eurozone, by contrast, the unemployment peak did not occur until June of 2013 at 12.1% and, while it has now fallen back to 9.6%, further declines in unemployment could fuel above-trend economic growth for many years year to come.

Another key factor is that the euro appears to be too low against the U.S. dollar. In 2016, the U.S. ran a current account deficit of roughly USD500 billion, or 2.7% of GDP while the eurozone ran a surplus of €200 billion, or roughly 2% of GDP. Since the euro was launched in 1999, it has traded at an average exchange rate of USD1.21. All of this suggests that the euro, at USD1.06, is significantly undervalued. For unhedged U.S. investors, a rebounding euro over the next few years should add a currency kicker to better local currency returns.

A little back of the envelope math can summarize the case for an overweight to European equities. If we assume:

- both European and U.S. earnings per share rise by 5% per year from 2018 on,
- both the S&P 500 and the MSCI-Europe revert to their 25-year average P/E over the next 5 years,
- the euro returns to its 18-year average exchange rate of USD1.21 against the dollar over the next five years, and,
- both European and U.S. stocks maintain their current dividend yields, then

European stocks could return 5.9% more per year than U.S. stocks, composed of a 1.6% advantage due to a smaller decline in P/Es, a 1.6% advantage because of higher dividend yields and a 2.7% gain due to euro appreciation.

This brings us to the third question. If fundamentals and valuations suggest European equities are undervalued relative to their U.S. counterparts, then what is it that is keeping them that way and will this go away?

One answer may simply be that investors are too optimistic about what political change could mean for U.S. equities and too gloomy about political change in Europe. In the U.S., while the country is very divided politically, the stock market appears to be taking an optimistic view about what the new administration could mean for stocks. However, this optimism could be a little overdone. In reality, barring a surge in immigration, there simply are not enough workers to allow the economy grow much faster.

The stock market would likely benefit from policies to reduce corporate taxes and regulation. However, it is more likely that the President and Congress will either severely limit corporate tax cuts and other stimulus in order to maintain fiscal discipline, or else, throw caution to the wind and over-stimulate a full employment economy, leading to higher inflation and interest rates. In addition, there is some risk of policies that could restrict trade and legal immigration, which could counter the positive effects of less regulation and lower corporate taxes. In short, as the political fog clears, the Washington landscape may not seem quite as market friendly as is being imagined by U.S. investors today.

Conversely, global investors seem to be hyper-aware of the political threats posed by populist parties throughout Europe, particularly with elections in France, the Netherlands, Germany and possibly Italy this year. However, in each case, the populists still look unlikely to win a governing position. If this continues, then European election results this year could actually reduce uncertainty and boost both the euro and stock prices.

In summary, while U.S. equities still look less expensive than Treasuries and cash, they are not as attractive as they once were. Investors looking for stronger long-term returns may find a better opportunity in European stocks.

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