

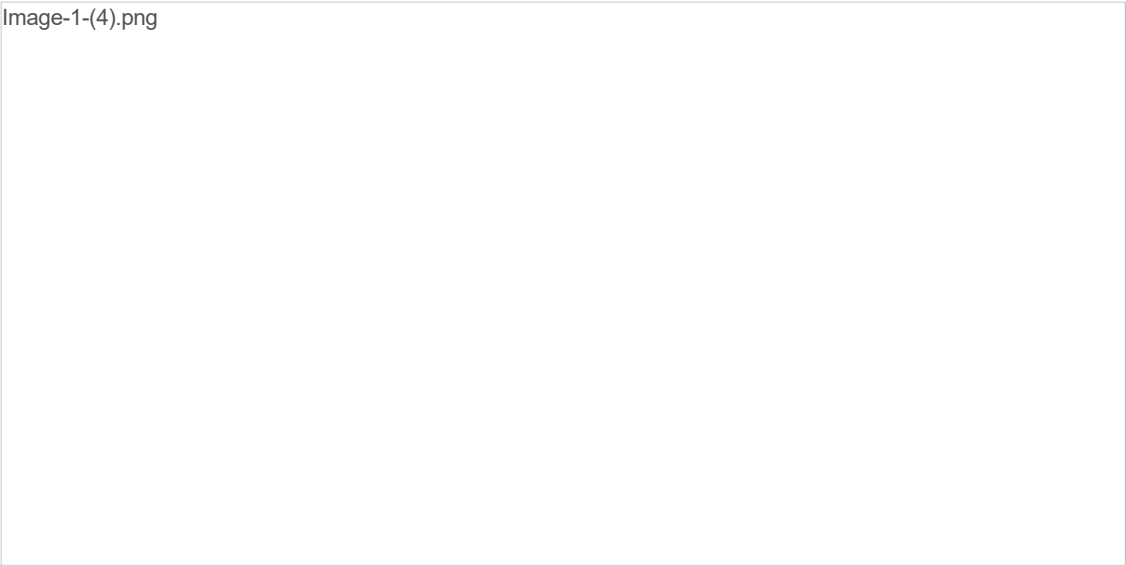
Opportunities in European equities?

By Barry Cowen, Fund Manager

Investing in European equities over the last 10 years has proven a real challenge, with net returns notably lagging North American equities, by circa 216% to 385%, in sterling terms.

This has not always been the case, though, and over the longer term (see chart below) they have kept pace, with recent North American outperformance arguably just catch-up.

Image-1-(4).png



Here is an expanded chart <

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Source: Morningstar, March 2019.

So what is behind their recent plight and is it likely to improve with the passage of time? Is now a good time for investors to consider investing European equities, and if not, what signs should they look out for?

Europe failing to follow US since 2008

Put simply, the European economy, relative to the US, has struggled to recover from the global financial crisis. European GDP growth, for instance, has trailed that of the US since 2008 and although the reasons behind this are many and complex, a major factor has undoubtedly been the slow recovery of the European banking sector.

The performance of the Eurozone economy is closely aligned with the health of its banking system, which is the largest in the world, providing circa three-quarters of corporate and nine-tenths of household financing. This is around double and triple the proportion, relatively, seen in the US, according to Deutsche Bank research*.

How European banks have been challenged

In the years since the global financial crisis the profitability of European banks has been challenged on several fronts, perhaps most perversely by European Central Bank (ECB) policy. Banks place 'excess' liquidity / capital with the ECB for overnight safekeeping. The stronger the bank therefore, the more excess liquidity is placed with the ECB.

However, in an effort to encourage lending the ECB has not only reduced interest rates to zero, but actually charges banks (0.4%) for the capital they lodge with it. In effect, core strength is being taxed, even discouraged, to the extent that the €2trn on deposit with the ECB, has cost the depositing banks circa €8bn (0.4%) per annum**.

By contrast, the Federal Reserve is currently paying US banks 2.4% on deposits of \$1.6trn (or \$38bn per annum)***. It is a delicate balancing act, but the ECB's desperation to encourage bank lending seems counter-productive. Moreover, this conflict inhibits the ECB from either reducing rates further, or raising them, leaving it veritably caught between a rock and a hard place.

During the same period regulation has spurred banks globally to increase their capital adequacy ratios, to make them safer. For European banks, they have moved from circa 9% in 2010 to around 14.5% in mid-2018. For US banks the aggregate capital adequacy ratio is around 13.3%. US banks were able to make these improvements while growing assets, because they entered the financial crisis with much lower leverage, than European banks. European banks have instead had to shrink assets to improve their capital ratios.

The shrinkage of assets, by European banks, has unfortunately impacted their profitability. So, although they are much 'safer', they are also far less profitable and this hardly inspires confidence. Rumours swirl and persist around Deutsche Bank merging all or parts of its business with others, to enable cost cutting and profit improvement.

How have these conditions affected European equities?

Given the prominent role of banks in the European economy, their trials and tribulations, and in particular, their challenged lending positions have undoubtedly had a negative impact on investor sentiment towards European equities. And whilst this hasn't stopped them rising, it has meant they have risen far less than their US peers.

On a traditional Price/Earnings ratio, European equities do not look bad value. As at 31st March 2019 the MSCI North America Index traded on a forward P/E ratio of 16.58, and a Price/Book Value of 3.23, while MSCI Europe ex-UK traded on a forward P/E of 13.72 and a P/BV of 1.78. So relatively speaking, they look cheap. Moreover, Europe is arguably better supported by a more attractive dividend yield of 3.47% versus 2.12% for North America.

That said US companies prefer to implement share buybacks as a more tax efficient way of returning cash to shareholders, so this is not necessarily a wholly valid comparison.

So why is there such a seemingly big difference in valuations between North American and European Equities? Is it just the impact of the banks?

One other reason may be the difference in Return on Equity (ROE).

Image-2.png



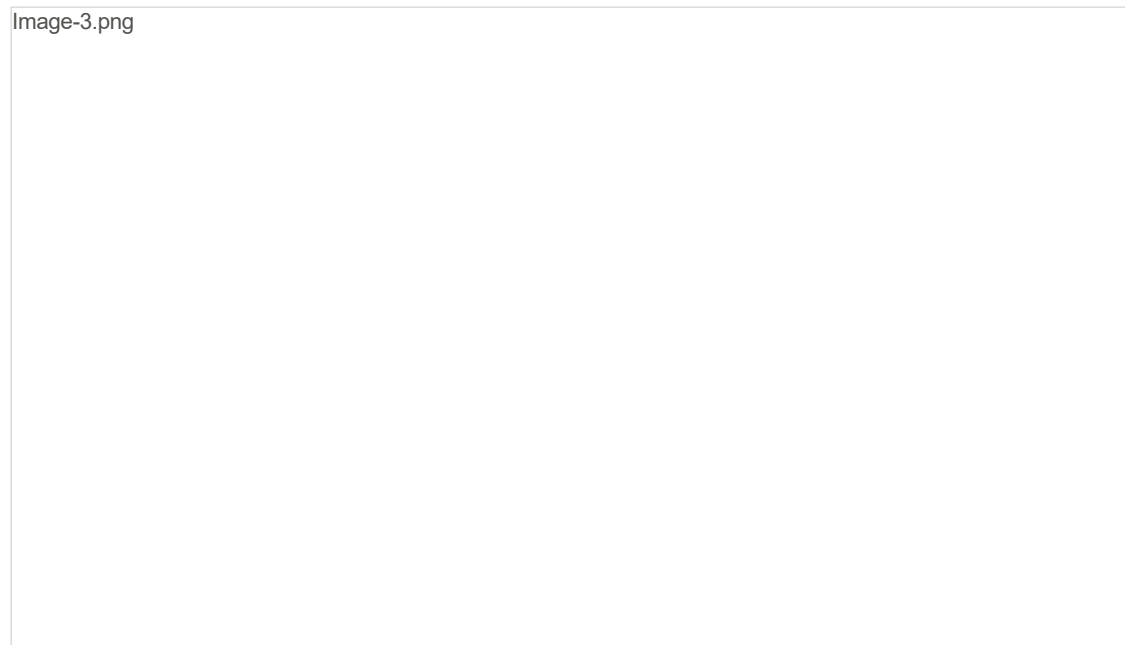
Over the longer-term European equities have been more competitive on this measure (ROE), but still lagged the US. From 31/3/97 to 31/3/2007 the average European ROE was 1.4% lower than in the US. Since then the difference has averaged nearly 2%.

An element of this difference is reflected in the relative 'style' biases of the indices. MSCI North America has more growth and fewer value stocks than MSCI Europe. And since the global financial crisis, persistently low long-term interest rates and low GDP growth rates have aided US growth stocks, with their long-duration, reliable earnings

streams, far more so than it has businesses with cyclical earnings, especially considering the cyclical recovery has not been that robust. Those growth companies tend to have a higher ROE than value businesses such as banks. So European stock indices' bias towards banks has hurt them relative to US tech indices with heavier exposure to Facebook, Amazon, Google etc. and consumer staples businesses such as P&G.

The bank woes have perhaps been a core issue, but significant also is the European dependence on demand for its manufactured goods. Yes, it's great to have a trade surplus (the US has a major trade deficit) but it does render an economy more dependent on external demand.

As shown below in the chart on the European Union Balance of Trade, the recent direction of this has not been good news, with export demand dropping sharply, by 15% from October 2018 to January 2019.



The US trade war with China is being blamed in large part for this, but it is instructive to note that EU exports to China, its second largest trading partner, grew 10% from Jan 2018 to Jan 2019. So, while the trade war may have impacted trade recently the trend is still positive. It is also worth noting that EU exports to the US (its largest trading partner) increased by more, 12.8%, over the same period.

What is the outlook for European equities?

Although they are not expensive it seems a pick-up in global demand for European goods and better profitability for its banks would be the key drivers for a meaningful recovery in European stocks.

After a tough 2018, China looks like it may be in the early stages of a gentle recovery. That could be good news for Europe. And in turn, with improved leverage ratios European banks are arguably better-placed to respond. All in all, this could be an early sign of future good news.

For a value investor, this possibly presents an opportunity, if all these elements correct, Europe could do very well.

But until the ECB finds a way to unpick the hole that has been created, it does seem the going won't be much better quickly. So patience may be required.

*Source: Jim Reid, Kinner Lakhani and Luke Templeman, Deutsche Bank: How to fix European Banking and why it matters, 12th March 2019

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***Source: MSCI

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