Why we find Europe attractive

Investors are fleeing from Europe as the European crisis sees no end. The foundation of the fiscal union is shaky enough to put entire countries' survival into question. We are all well aware of the prevailing problems in Europe, but is that the full picture? Will the sun rise again tomorrow, or will this be the definite end? In this analysis we express our view of the European equity market.

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Europe is on everyone's lips but not in anyone's portfolio. According to EPFR Global and BofA Merril Lynch global investors has this year (per May 31) pulled out a net $3.8 billion from both active and passive long-only funds. In the long-only funds investing in EM (Emerging Markets) investors has allocated $14.8 billion while withdrawing $18.6 billion from long-only funds investing in DM (Developed Markets). In European focused long-only funds alone investors have withdrawn $18.8 billion - the outflows from long-only funds investing in DM is entirely due to investors seeking shelter from Europe. Investors have no problem with investing in DM, but they shun Europe.

The flows speak for themselves, it is apparent that significant discrepancies have emerged. This is still the case when it comes to other variables and circumstances. We have identified three reasons that advocate a turn-around and describe why we find Europe attractive:

1. The European equity index, MSCI Europe, is currently trading at 9.3x the 12-month forward earnings, as shown in figure 1. This is much lower than the historical valuation average (excluding the dot-com bubble) of 13.4x. During the worst period of the financial crisis, in the end of 2008, the valuation reached the lowest point of the period at 7.0x for the 12-month forward earnings. The European equity index is currently trading at a discount of 31% against the average historical valuation, but at a premium of 33% against the absolute rock-bottom point during the financial crisis in 2008.

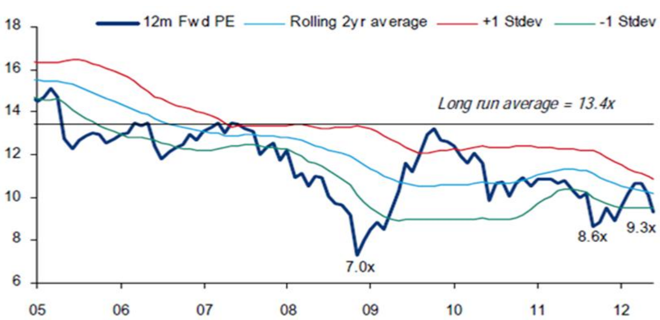

Figure 1. *The European equity index is today valued at 9.3x the 12-month forward earnings which offers a large discount in relation to the historical valuation of 13.4x, but a premium against the absolute rock-bottom during the financial crisis at 7.0x. Source: BofA Merrill Lynch European Equity Strategy.*

We find the ratio Graham-Dodd P/E (also called Schiller P/E) to be more reliable as the traditional P/E tends to over- or underestimate the earnings of the companies. The Graham-Dodd P/E is calculated by using the current price in relation to the inflation-adjusted average earnings for the last 10 years. By using this ratio, MSCI Europe is today trading at 12.7x as seen in figure 2. This can be compared to the average historical (1979-2012) valuation, excluding the dot-com bubble, at 19.4x. During the financial crisis the Graham-Dodd P/E hit bottom at 9.9x. The European equity index is currently trading at a discount of 35% against the average historical valuation, but at a premium of 28% against the absolute rock-bottom during the financial crisis of 2008.

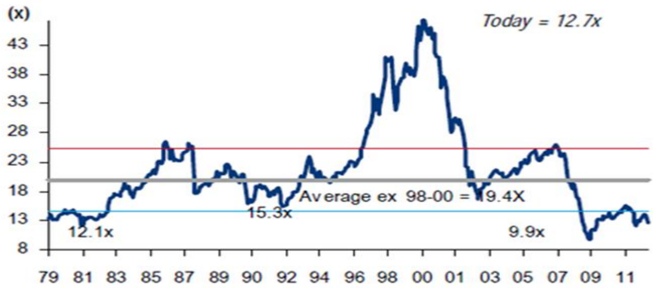

Figure 2. *The European equity index is currently valued at 12.7x the average of the earnings over the last 10 years, which offers a large discount against the average historical valuation of 19.4x. Source: BofA Merrill Lynch European Equity Strategy.*

2. The U.S. market has in the recent years functioned as a safe haven for investors, a trend which is visible in both performance and valuation. It has been an appreciated shelter as the European market (MSCI Europe) has struggled; MSCI Europe has during the past 36 months underperformed by 40.4% against the U.S. market (MSCI USA), both in USD, see figure 3. Underperformance of this extent has only occurred during three earlier periods since 1969: 1982-1985, 1993 and 1997-1999. The following 36 month period after the first occurrence between 1982-1985 MSCI Europe outperformed by 114% compared to MSCI USA; the following 36 months period after the second and third occurrence MSCI Europe outperformed by 6%, respectively 12% against MSCI USA. Throughout the historical periods where the underperformance has been of today's magnitude, Europe has in relative terms, been a better investment than the U.S. market.

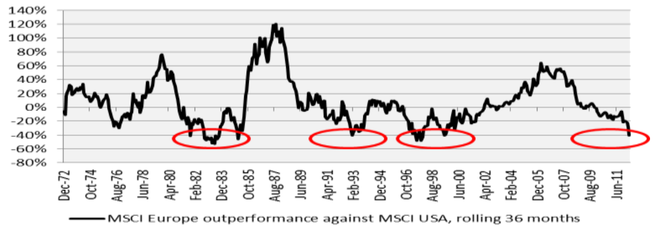

Figure 3. *The underperformance of MSCI Europe against MSCI USA, on a rolling 36 months basis, is today at levels only seen three times earlier since 1969. Source: MSCI, CB Asset Management.*

The extended period of underperformance for Europe against the U.S. market, including the severe underperformance the past 36 months, has resulted in significant discrepancies in the valuation between the European and the U.S. stock markets. The expected earnings for the coming 12 months of the European companies are currently only valued at 80% of what the equivalent U.S. companies are, according to BofA Merrill Lynch. The difference becomes more evident when we turn our eyes to the valuation of the historical earnings, i.e. the Graham-Dodd P/E. European companies are presently valued at a discount of 40% against U.S. companies - during the last 30 years there has not been a single occurrence with a discount of this proportion, as shown in figure 4.

Figure 4. *Looking at the valuation of the average historical profit for the past 10 years the difference between Europe and U.S. has not been as large since at least 1980. Europe is presently trading at a discount of almost 40% against the U.S. market. Source: BofA Merrill Lynch European Equity Strategy.*

3. The low valuation and the substantial underperformance of European companies stem from the well-known problems in Europe. There is no denial of the existence of problems within the European Union; however, it is not obvious that the European companies have problems. In fact, 44% of the earnings of European companies are derived from EM, which is twice that of U.S. companies, according to Citigroup. In regards to sales, large European companies has the highest exposure against EM (~29%), followed by mid-sized companies (~27%) and small companies (~15%).

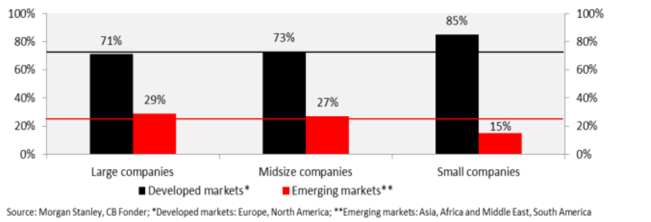

Figure 5. *European companies in average have high exposure against EM. The highest exposure is by large companies (~29%), followed by mid-sized companies (27%) and small companies (~15%). The average exposure against EM for European companies is 24% (represented by the red line) and 76% against DM (represented by the black line). Source: Morgan Stanley Research, CB Asset Management.*

The flip side of exposure is that there is no correlation between economic growth and return on the stock market; European stocks do not have to be a bad investment/exposure simply because Europe is troubled by a low growth, just as Chinese stocks do not have to be a good investment/exposure just because China has high growth. How profitable an investment is does not depend on the growth of the region in which the investment is done, it is determined by the valuation it has. Europe is presently valued at a Graham-Dodd P/E of 12.7x, historically markets with the equivalent average valuation has yielded a return of ~10% in the following 10 years. Markets with a "normal" nominal economic growth has historically yielded a return higher than markets with high growth (>7%/year). Valuation matters, GDP-growth does not.

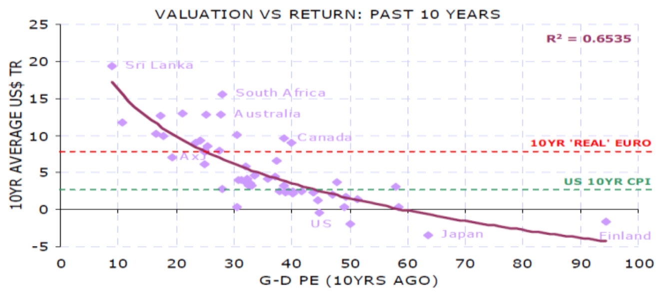

Figure 6. *Historically there is a strong correlation between low Graham-Dodd P/E and a high subsequent 10 year return. Source: Morgan Stanley Research.*

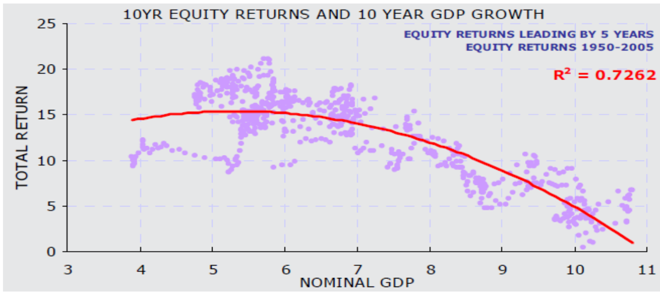

Figure 7. *The correlation between a high nominal GDP-growth and a high return on the stock market is low. Rather, the opposite applies (to a certain extent). Source: Morgan Stanley Research.*

Conclusion: Looking both from an absolute and relative perspective, Europe is cheap compared to U.S. As always, it can get cheaper and trends usually tend to last longer than expected. The financial crisis is a good example of that and to those levels there still is a long way to go. Europe has problems but many European companies do not, choosing stocks based on the macroeconomic circumstances for the markets they are listed on is usually wrong – you can't judge the book by its cover.

If you have any questions or remarks, please contact us by e-mail info@cbfonder.se or by phone +46 8-566 133 10.

We wish you a nice summer!