Invesco

Investment Insights
A contrarian view on Europe

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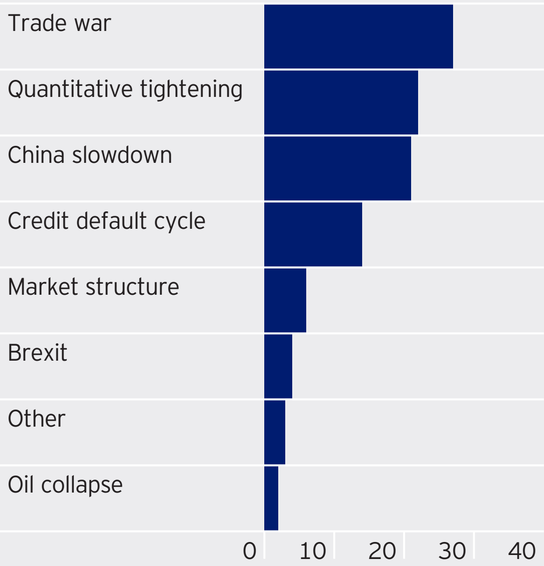
European Equities Team
Henley Investment Centre

Economic clouds are somewhat darker in Europe compared to this time last year, but we are not subscribers to the notion of an economic Armageddon. European equity markets are trading well below levels seen at the end of 2017 as investors have penalised the asset class in response to several challenges – some of Europe's own making and some from further afield. Against this backdrop, we look at what is driving investor sentiment, how recent economic data will impact long-term growth, and which areas of the market look most attractive.

Greatest fears for 2019

Investors today are as bearish on the outlook for the global economy as they were in the last two recessions. Based on a survey of global fund managers in January 2019, 60% expect global growth to decelerate in the next 12 months driven by a combination of trade wars, china slowdown, and quantitative tightening.

Figure 1
What do you consider the biggest "tail risk"?



Source: BofA Merrill Lynch Global Fund Manager Survey (January 2019 survey).

China and trade

The trade tension between the US and China has been a major cause of market anxiety in recent months. Whilst geopolitics mean that tension is likely to remain a feature of the political landscape for some time to come, the nearer term reality of President Trump gearing up for a 2020 re-election bid makes some short-term easing of rhetoric likely.

There is also a building war of words between the US and the EU, which will need to see trade issues addressed. Ultimately trade between the US and the EU forms the largest bilateral trade flow in the world, with US exports to and from the EU in 2018 estimated at $570bn and $670bn respectively. As a result, reciprocal action taken by the EU to sanctions imposed by the US has the potential for much wider impact, and there is weaker US political support for a trade war. However, there is scope for a barrage of tweeting to cause some market volatility.

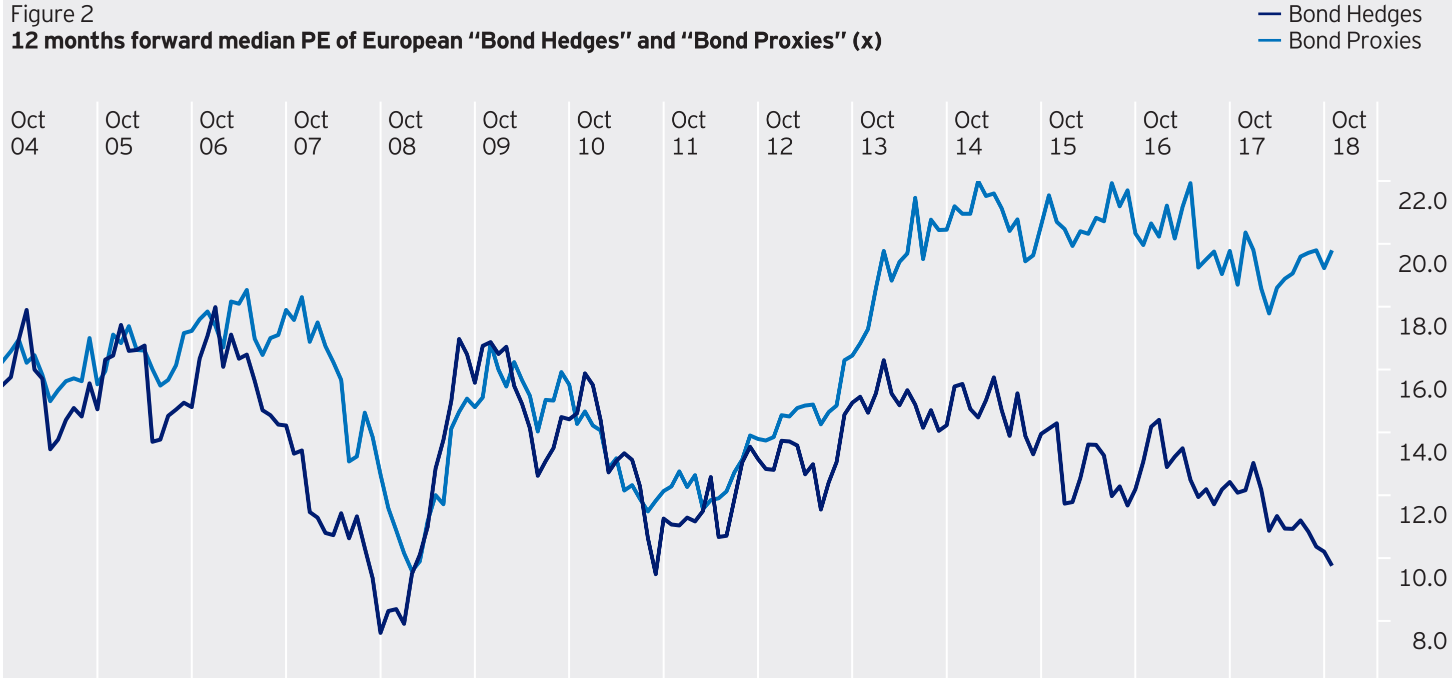
A slowdown in China, the world's second largest economy, has been a key worry for investors. However, there is evidence that the Chinese authorities have implemented stimulus measures to help mitigate some of the impacts. Meanwhile (as we discuss later), robust domestic demand in Europe helps mitigate some of the export driven impacts.

Monetary policy

Quantitative tightening (QT) on a major scale now seems highly unlikely in Europe this year. Especially following the European Central Bank (ECB) press conference in January where the Central Bank maintained its commitment to leave interest rates unchanged "at least through the summer of 2019, and in any case for as long as necessary". However, the process of a shift from quantitative easing (QE) to QT does mean liquidity being withdrawn from the market – very slowly, but surely – and the cost of capital for borrowers gradually beginning to rise. The winners of extremely accommodative monetary policy over the past decade have been the bond market and equities that most represent its qualities ('bond proxies' i.e. Long Duration, Stable, 'Quality'). The losers have effectively been short-duration ('bond hedges' i.e. Cyclicals, Financials, 'Value'). This has led to the valuation gap between those two groups becoming very stretched.

To be clear, we are not taking a top-down view on where bond yields 'should' be. More, our stance is that given the valuation skews apparent in the European market today after the best part of a decade of extreme monetary policy, the valuation risk reward has shifted firmly towards owning the sectors which have been most negatively impacted by that policy.

Figure 2
12 months forward median PE of European "Bond Hedges" and "Bond Proxies" (x)



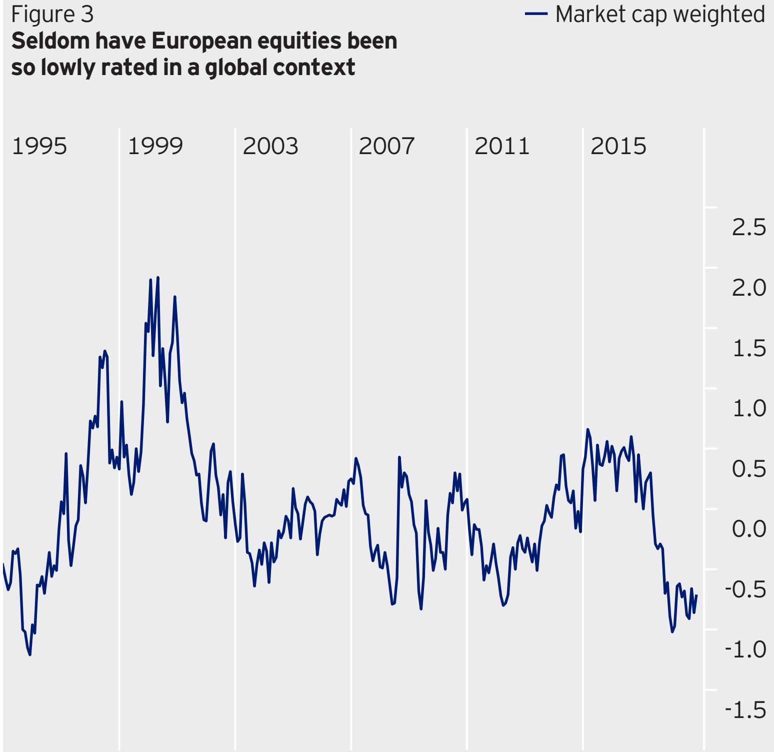
Source: SG Cross Asset Research/Equity Quant, Invesco as at 30 November 2018. Using 60 months correlation the MSCI Europe universe both The two portfolios – Bond Hedges and Bond Proxies - are created by ranking MSCI Europe on a 60 months correlation to US 10 year Treasuries.

Valuation

From a valuation perspective, European equities have not been this unloved for quite some time. Using an average of nine common valuation metrics, the chart to the right plots the relationship between two popular indices that represent equity markets in Europe and the rest of the world, MSCI Europe and MSCI AC World. The discount for Europe is at or below levels reached in the Sovereign Debt Crisis of 2011/2012 and the Global Financial Crisis of 2008/2009. Do fundamentals support this sentiment?

Though recent macroeconomic data such as PMI, IFO, and GDP growth have been weaker than expected, they have been impacted by some one-off events: new WLTP diesel regulations leading to a severe fall in car production; a 200-year low in the Rhine River's water levels causing a disruption in the transport of goods; and the 'Gilets Jaunes' protests across France. WLTP and Rhine effects appear to have largely normalized whilst in France, though the protests have continued, recent opinion polls now indicate falling levels of support for the 'Gilets Jaunes' and rising popularity for President Macron. As the year progresses, a reversal in the impacts of some (if not all) of these temporary issues should be reflected in improving macro-economic data - some of which we are already starting to see (e.g. December's sharp uptick in auto-related industrial production).

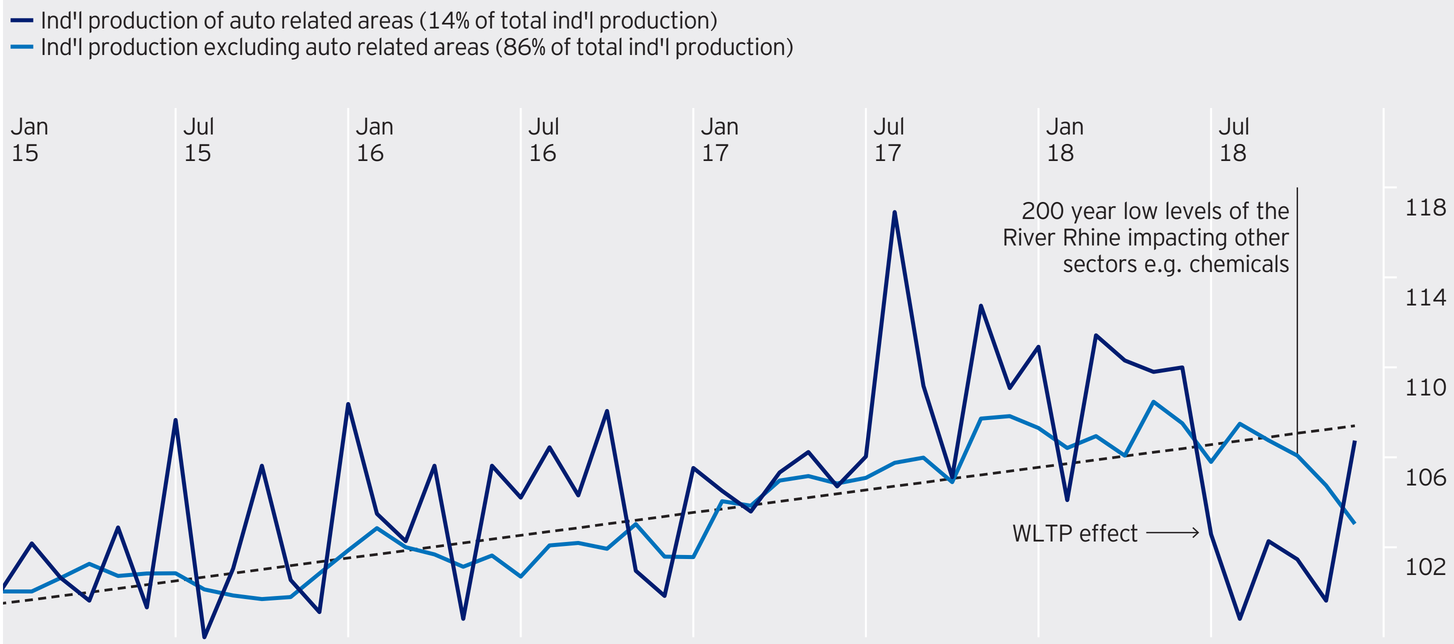
Figure 3
Seldom have European equities been so lowly rated in a global context



Europe valuations rel to AC World on avg of 9 different metrics SD since 1995

Source: Morgan Stanley Research, MSCI, IBES as at 31 December 2018. *Values calculated as an average of the z score of 9 different valuation metrics (P/E, P/D, P/B, P/CE, P/S, EV/Sales, EV/EBITDA, EV/EBIT and price to forward earnings). Market cap weighted. SD = Standard Deviation.

Figure 4
German industrial production-ex cars and auto related industrial production



Source: Credit Suisse as at 25 February 2019. WLTP = Worldwide Harmonised Light Vehicle Test Procedure.

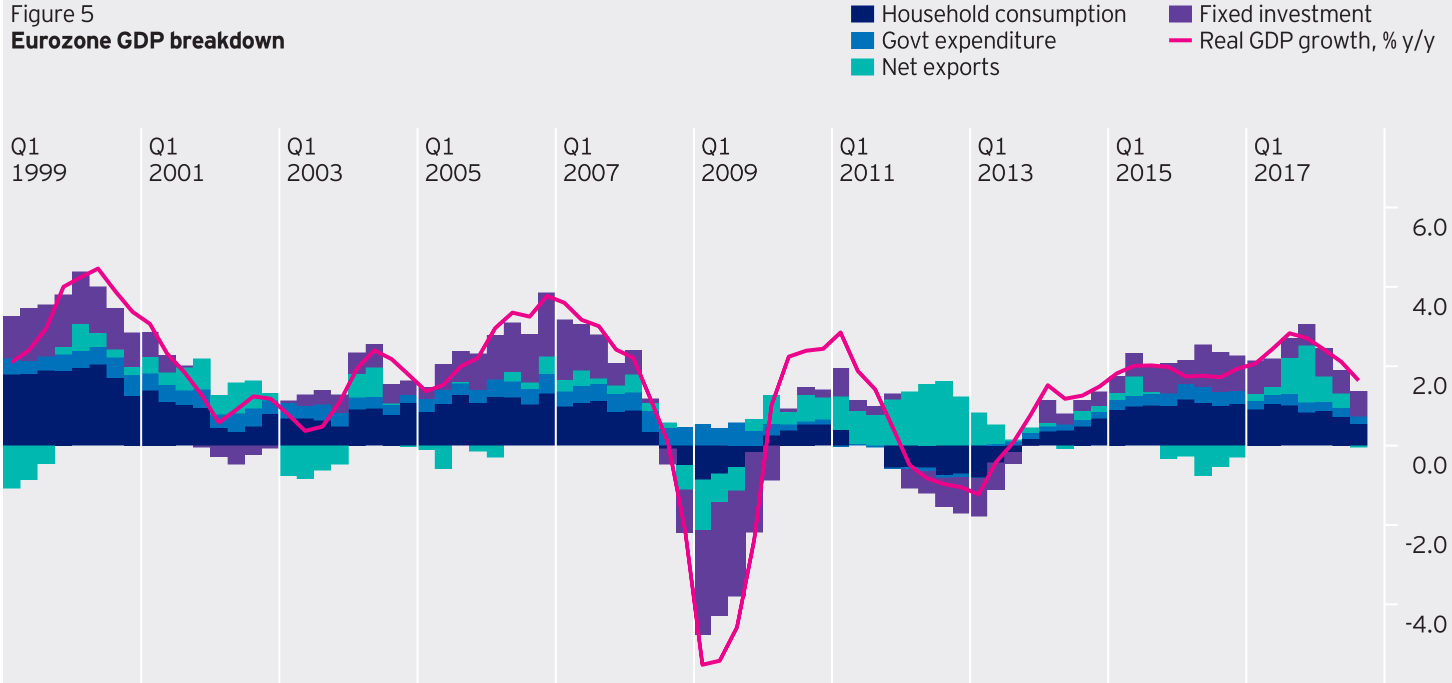
Furthermore, it should be noted that the Eurozone is not only an export driven economy. Domestic demand has remained robust driven by falling unemployment levels, rising wages, and private sector loan growth – all of which remain healthy.

Where do we see the best opportunities in the European market? Our approach has long been based on valuation: we look for mispriced stocks in all sectors of the equity market and we find that the disparities between stocks, sectors and styles are particularly wide at present. Indeed, the most attractive valuations are currently to be found at the value end of the spectrum. 'Value' does not mean 'bad companies'; we can find many good quality businesses, with strong balance sheets, well-covered dividends and robust free cash flow in a wide range of sectors. We discuss a few of them in the following sections.

"As active fund managers who think long term, we endeavour to take advantage of valuation anomalies in the market for the benefit of our investors. While spending a lot of time on stock picking, we also keep an eye on the economic background as that can clearly influence the investment choices we make."

Jeff Taylor
Head of European Equities

Figure 5
Eurozone GDP breakdown



Source: UBS, Haver as at 31 Dec 18. Data up to and including 30 Sep 18 (latest available). Differences between the sum of the individual components and the total are changes in inventories.

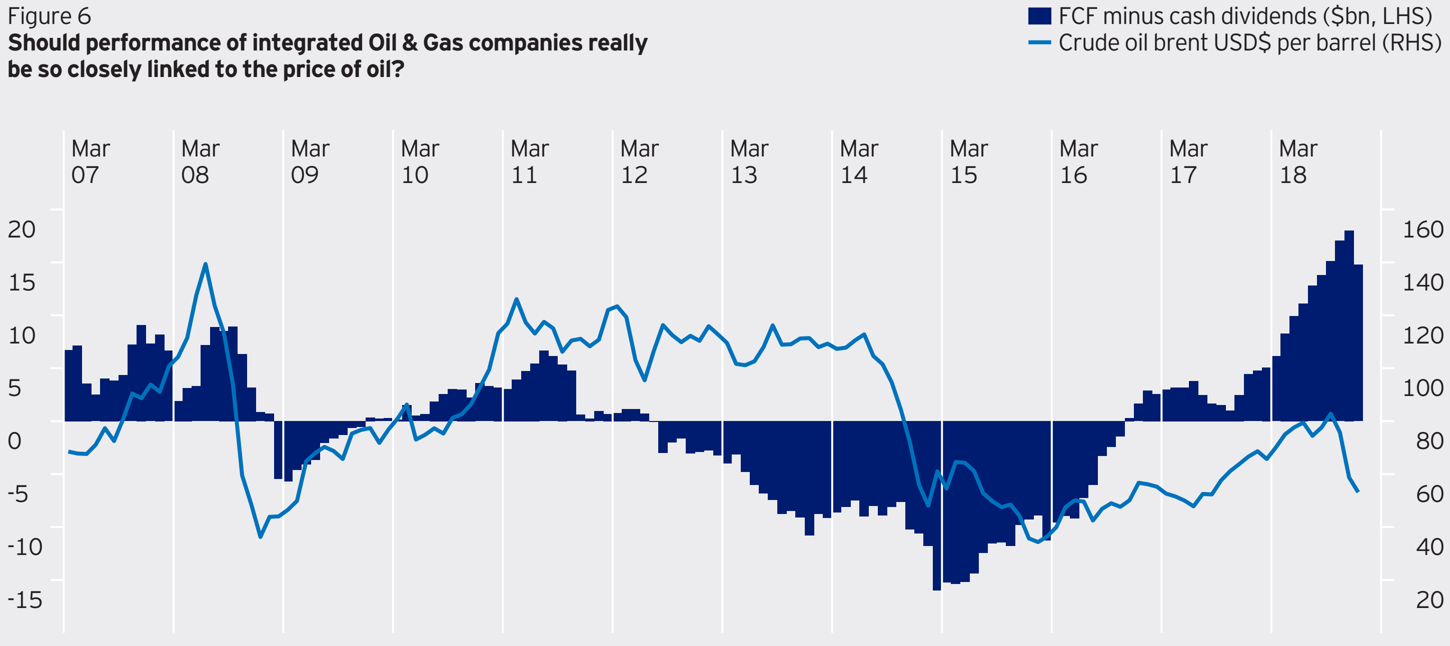
Oil and gas
Energy is a key overweight across the European team's portfolios. The investment thesis is based on the capital discipline that has been in place in the industry since major management change at the end of 2013. Our view has been that for any given oil price, the returns generated this cycle will be greater than witnessed in the previous cycle. The chart below demonstrates the sector is clearly delivering on this; even amidst falling oil prices, firms today are still producing strong positive free cash flow.

The spot oil price can witness considerable volatility in the short-term. The wild swings witnessed during the back-end of 2018 took Brent from above $85/bbl in October to just over $50/bbl by December. However, daily spot commodity trading is dominated by financial players not physical trading – money managers in aggregate hold six times the level of physical demand – exposure to the sector brings with it an increased level of volatility with short-term share performance being highly correlated to oil price moves. Ultimately the long-term oil price is a function of global supply and demand. Although we steer clear of having specific oil price targets, we do expect a tightening in the market from here. Given the fundamental case for owning the sector has not changed, we prefer to take a long-term view rather than reacting to short-term 'noise'.

"We recognise that exposure to the sector in the short-term can bring with it additional volatility as the market can become hyper-sensitive to moves in the oil price and trade the equities accordingly. Businesses, we should not forget, work on decade-long timeframes and are very strategic in their behaviour."

Stephanie Butcher
European Equities Fund Manager

Figure 6
Should performance of integrated Oil & Gas companies really be so closely linked to the price of oil?



Source: Datastream, Morgan Stanley, Invesco, as at 31 December 2018. [1] Based on the constituents of MSCI Europe ex UK Integrated Oil & Gas companies – ENI, GALP, OMV, Repsol, Statoil, and Total (GICS Sub Industries classification) and aggregating individual company bottom up forecasts as provided by Datastream. Free Cash Flow formula = (12mths Forward CPS * no of shares (IBES)) minus 12mths Forward Capex = Free Cash Flow. Dividends formula = 12mths Forward DPS * no of shares (IBES). $ = USD.

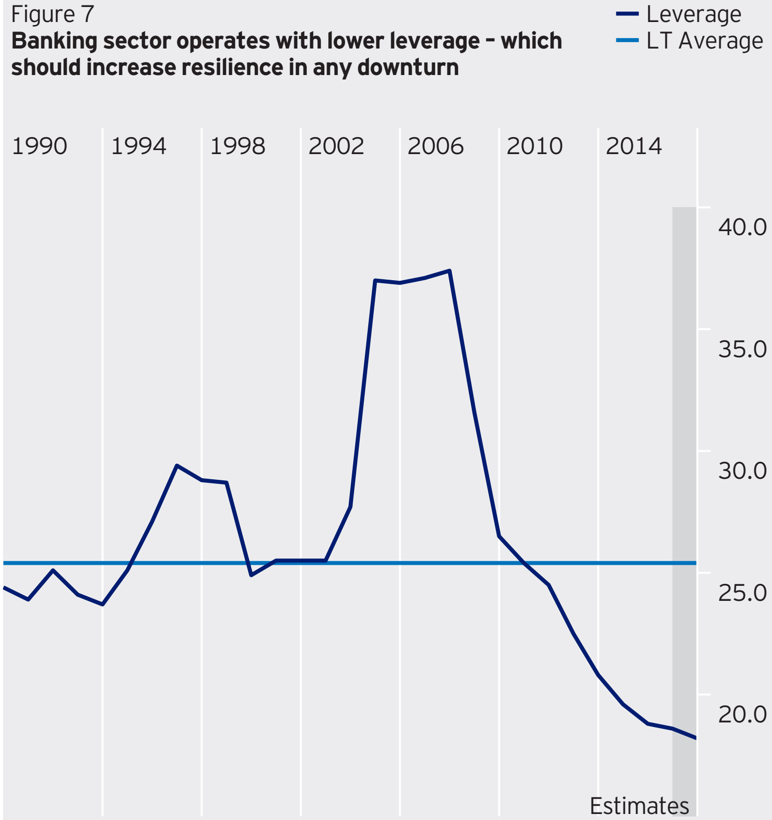
Financials
Banks are another important sector for the team and maintaining our conviction has not been particularly easy in recent times.

It would seem markets are pricing in a recession for European banks with current prices implying a circa 30% fall in 2019 earnings. Return on Equity for European banks relative to the market has been moving up yet the Price to Book ratio has been falling. This implies concerns beyond cyclical earnings risk linked to a concern that the ECB has 'missed' its opportunity to raise rates for this economic cycle. In this context it is notable that a number of members of the ECB Governing Council have recently referred to the punitive nature of negative deposit rates on the region's banks. Movement in policy here is simply not priced in.

"If we had to use negative rates for a longer period than expected, we should study pragmatically how to contain their possible adverse effects on the bank transmission of our monetary policy" - François Villeroy de Galhau, Governor of the Bank of France.

Valuations at current levels equate to those reached in major macro-economic events historically: the global financial crisis (GFC), the European Sovereign debt crisis and the Brexit vote. We do not see the same systemic risks evident in the market today. In addition, importantly, banks capital ratios, balance sheets and liquidity ratios are far more robust than in those previous events. Current valuations provide no acknowledgement of the stronger state of bank finances nor any degree of economic or rate policy upside and as such, we believe the risk/reward to be very attractive.

Figure 7
Banking sector operates with lower leverage – which should increase resilience in any downturn



Source: Autonomous, as at 3 January 2019. Data shows adjusted assets/Trading Book Value.

Figure 8
European banks price to book relative to European equities markets, %

Source: Thomson Datastream, Invesco, as at 31 December 2018. Data based on Thomson Datastream Pan European Indices.

What's expensive?
All sectors see earnings fall in a recession, the question is one of degree. As an exercise we looked at the degree of earnings growth or contraction required to take each sector in the European market back to its long-term average valuation level. What concerns us is that valuations today imply for some sectors that earnings would actually increase in a recession or fall to a very limited degree. We then looked at what actually happened in the past two recessions. The example below shows why we struggle to want to allocate heavily to sectors such as Food Producers and Luxury Goods at this point in the cycle.

Our analysis shows that the Luxury Goods sector is highly correlated to the economic cycle and any downturn would mean a significant fall in earnings. A return to average valuations implies only a 2% fall in earnings. This seems very optimistic considering that in last two recessions earnings contracted by 48% (GFC) and 47% (dot-com crash). Likewise, valuations for Food Producers today are implying a 9% growth in earnings, even though in previous recessions earnings fell by 19% (GFC) and 11% (dot-com crash).

As a comparison, a return to long-term valuations in the Bank sector implies a fall in earnings of 31% - which is what happened in 2001/2002.

Essentially, the point we are making is that the market is pricing in a recession-style hit to earnings for some sectors and growth in earnings for others which we believe offers a valuation opportunity. If there were a recession in Europe in 2019 (which we believe unlikely), the sectors we are exposed to discount a likely fall in earnings to some degree. On the other hand, if things prove to be 'less bad' than markets are fearing, there is significant upside potential. Meanwhile, given current valuation levels for sectors such as Food Producers and Luxury Goods, there is potentially more earnings risk than the market is currently discounting. They are excellent businesses but we are not of the view they are defensive investments.

Final thoughts
Given the increasingly volatile trading sessions lately, we wanted to end with something which may ease the minds of disciplined investors – the relationship between starting valuations (represented by CAPE) and subsequent compounded annual growth, on a long-term (ten year) and short-term (one year) basis.

When looking at the one year correlations, it is apparent that the relationship between starting valuation and subsequent performance tends to matter very little. However, the same analysis using a ten year time-horizon shows evidence of a strong inverse relationship between future performance and starting valuation. In short, this supports our belief that valuation is the key factor to long-term sustained performance, while the short-term tends to be dominated by 'noise'. Given we have had an abundance of 'noise' lately – US-China trade war, Brexit, Italian politics, and stirrings of populism across the globe to name a few – it will come as no surprise that fundamentals are being largely ignored today.

As doubt seems to reflect fear rather than reality we must ask ourselves what constitutes true investment risk for our clients? If assets perceived to be 'low risk' are trading at all time high relative valuations, are they really safe? Equally, if stocks which may be cyclical are trading at historically low valuations, does that constitute risk or opportunity?

Even good companies can be bad investments, if the entry price is not right.

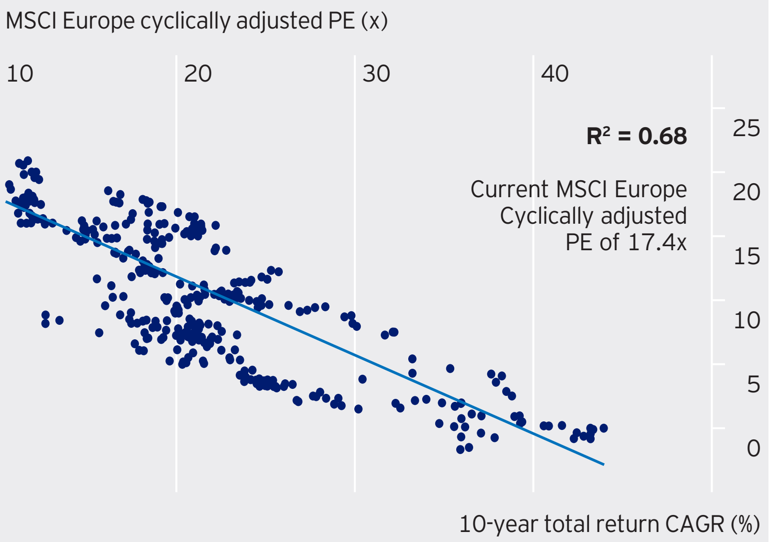
Figure 9
Areas at risk if a recession was really on the cards?

Europe ex UK sector	Food Producers	Luxury Goods
% change in 12m fwd earnings estimates to return to average long run sector PE	9%	-2%
12m fwd EPS fall 2001-2002	-11%	-47%
12m fwd EPS fall 2007-2009	-19%	-48%

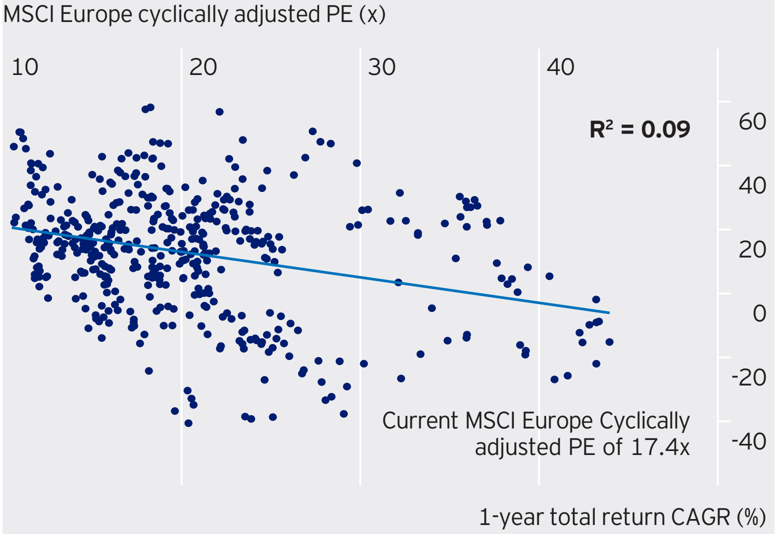
Source: UBS, Datastream as at 18 December 2018. UBS estimates from current share prices to see what cuts to consensus earnings are needed for P/E multiples to get back to long-run averages.

Figure 10

MSCI Europe: Historic starting CAPE and subsequent 10 year following nominal compound returns



MSCI Europe: Historic starting CAPE and subsequent 1 year following nominal compound returns



Source: Citi, Thomson Datastream as at 31 Dec 18. Each square/data point on the chart (monthly frequency) maps the starting cyclically adjusted PE ratio from 31 Dec 79 to 31 Dec 08 (based on one/ten years average historic earnings with the underlying data starting from 31 Dec 69) to the subsequent one/ten-year total nominal return up until 31 Dec 18 (expressed as an average annual nominal growth rate and based on historic data). Through regression analysis a line of best fit is calculated, based on the two data sets that make up each square (all historic data).

Risk Warnings

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