

Europe

Emerging from a Troubled Decade

THEMATIC PLAYBOOK | MarketDesk Investment Strategy

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Europe: Emerging from a Troubled Decade

THE QUICK NUMBERS

-218%

European equities' underperformance relative to U.S. equities from 2010-2019 (Source: MarketDesk Research, FactSet)

3.3%

IMF's 2020 global growth projection, up from 2.9% global growth in 2019 (International Monetary Fund - as of 01/20/2020)

+\$2.2Bn

Inflows to European focused ETFs over past 3mo; Sharp turnaround after 2yrs of outflows. (Source: MarketDesk Research, FactSet)

WHAT'S HAPPENING?

International equities underperformed U.S. equities over the last decade. U.S. equities produced a total return of 346% between 2009 and 2019. Over the same time period, emerging markets produced a 125% total return, developed markets produced a 115% total return, and Europe produced a 128% total return. The reasons for U.S. outperformance are widely documented. Stronger economic and corporate earnings growth. A stronger USD raised the cost of servicing dollar-denominated loans. The ongoing U.S.-China trade dispute widened the U.S. vs international equity story as investors feared the impact of a China slowdown on international equities. However, there are signs the backdrop for international equities has improved recently after a decade of underwhelming performance and negative storylines.

MARKET OPPORTUNITY & INVESTMENT CASE

Europe is emerging from a disappointing decade. The continent faced increased political uncertainty, a sovereign debt crisis, and weak global economic growth. Investors underweighted the region. However, there are signs that the trend of European equity underperformance could be reversing.

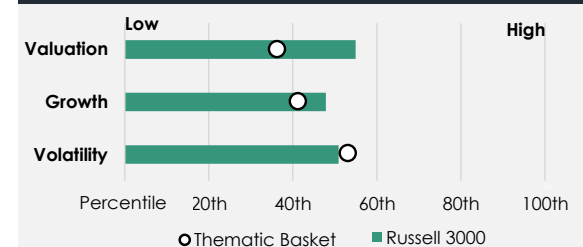
Below are three reasons investors should increase their allocation to European equities:

- Current Valuation Levels vs U.S.: European equities struggled to overcome multiple negative storylines over the last decade. Continent-wide and individual country political crises. Weak corporate earnings growth. Disappointing economic data. These issues combined to pressure European equity valuations and resulted in a widening valuation gap relative to U.S. equities. In our view, the current EU-U.S. equity valuation gap prices in the majority of the above risks. It provides a margin of safety, which allows investors to be more patient as the earnings story develops.
- Embedded Optionality from Higher Emerging Markets Exposure: Europe tends to be more cyclical and exposed to emerging market (EM) growth than the U.S. Over the last decade, Europe's EM exposure was a negative due to the impact from low global growth and weak commodity prices on EM economies. Now that a U.S.-China trade deal is signed and global central banks are engaged in monetary easing, Europe's EM exposure turns into a positive in our view.
- Divergent Policy & Political Uncertainty: During the last decade, Europe experienced a significant amount of political uncertainty due to the UK's decision to leave the EU and the rise of far-right government in individual countries. U.S. politics were relatively more stable. Now the roles are reversing. In Europe, there is a clearer Brexit path, and the EU has moved away from the brink of total collapse. In contrast, the U.S. holds elections in 2020, and the Trump administration has increasingly taken an isolationist stance. The diverging political fortunes support European equities in our view.

Key Statistics

Region	Europe
Sector	Broad
Holdings	1
Average Market Cap (\$M)	\$15,362
NTM Price / Earnings	13.6x
Price / Book	1.7x
EV / EBITDA	9.5x
Price / Cash Flow	16.0x
Dividend Yield %	3.77%

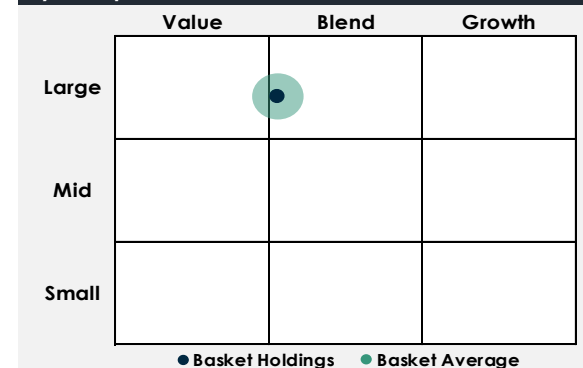
Investment Profile



Price Returns

	Basket	Russell 3000
3 Month	↑ 3.8%	↑ 8.5%
6 Month	↑ 12.8%	↑ 15.6%
1 Year	↑ 10.7%	↑ 20.4%

Style Map





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Figure 1: European Valuations Attractive vs U.S. Peers...

- U.S. equities trade +1.6 stdev above their 10yr valuation composite average. European equities trade +0.5 stdev above their 10yr valuation composite average.
- In our view, the margin of safety allows investors to own European equities as the earnings story continues to develop.

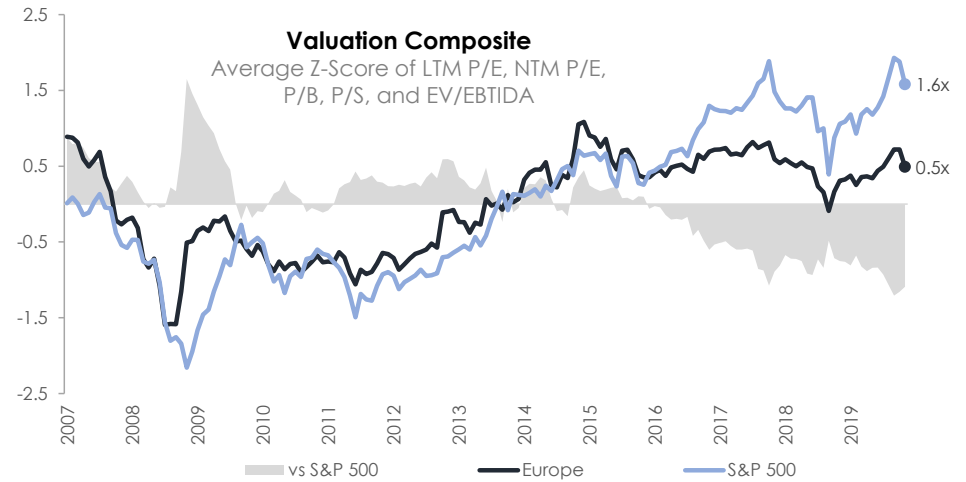
Figure 2: European & Global Manufacturing PMIs Nearing Bottom...

- After ~2yrs of steady declines, global and EU manufacturing PMI data are flattening and heading higher. This could indicate global manufacturing activity is improving.
- Due to Europe's sensitivity to global trade and economic growth, an improvement in global manufacturing data would benefit European equities.

Figure 3: Flows into European ETFs Turn Positive...

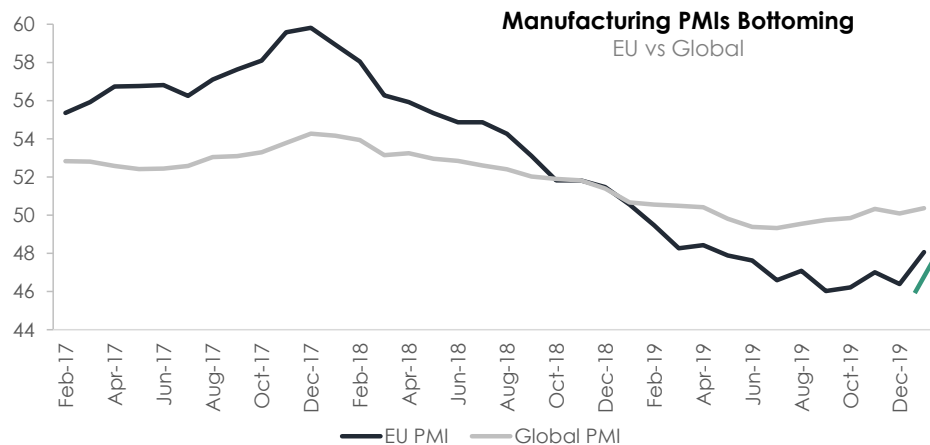
- Investors are taking notice of the attractive valuation and encouraging PMI data. Flows to European focused equity ETFs turned positive over the past 3mo after almost 2yrs of steady net outflows.
- From a portfolio allocation perspective, investors generally remain underweight European equities. In our view, this indicates the recent inflow trend could continue over the coming months and years.

FIGURE 1: European Relative Valuations at Decade Low



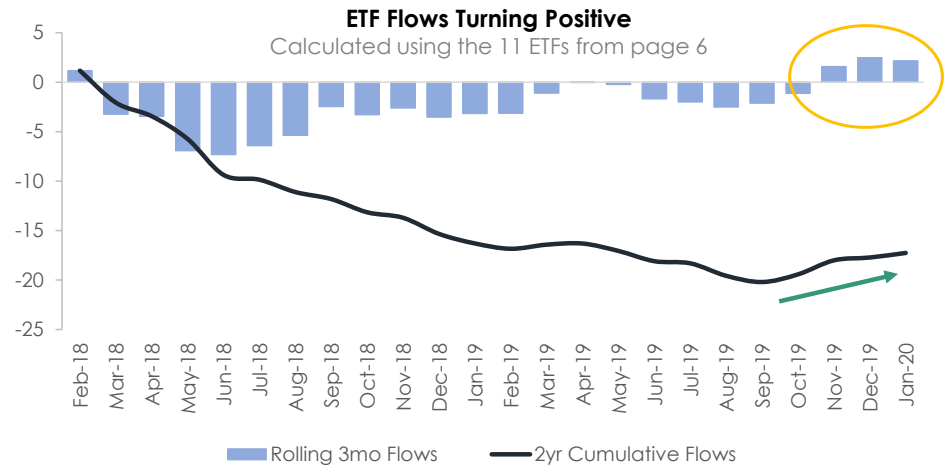
Source: MarketDesk Research, FactSet

FIGURE 2: European PMI's Tend to Lag Emerging Market PMIs



Source: MarketDesk Research, FactSet

FIGURE 3: European Focused ETF Flows Turn Positive



Source: MarketDesk Research, FactSet

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WHAT'S THE TIMELINE?

The last decade for European equities shows there is no set timeframe for a global region to turnaround. However, the ingredients are coming together for European equities to outperform. European equities' valuations are attractive relative to U.S. peers. Global trade is moving toward normalization after the U.S.-China trade deal was signed and NAFTA 2.0 was finalized. The U.S. is entering a year of political uncertainty, while Europe is moving away from the brink of total collapse. **In our view, European equities are attractive today. Investors should increase their portfolio allocation to Europe.**

CATALYSTS ↗

- Current EU valuations provide a margin of safety for investors
- A U.S.-China trade deal & improving global PMI could support EU equities
- Relative underweighting to the EU region in investor portfolios

Figure 1 shows the valuation gap between U.S. and European equities is at a decade high. Based on a valuation composite that includes LTM P/E, NTM P/E, P/B, P/S, and EV/EBITDA, U.S. equities trade +1.6 stdev above their 10yr valuation composite average. European equities trade +0.5 stdev above their 10yr valuation composite average. In our view, this valuation gap provides investors a margin of safety. The margin of safety allows investors to own European equities as the earnings story continues to develop.

European companies tend to be more highly correlated to global growth than their U.S. peers. During the past decade, this was a negative for European equities due to low global growth and weak commodity prices. However, that could be changing today. The recently signed U.S.-China trade deal and improving global PMI could give businesses the confidence to resume spending plans that were stalled recently. European equities are more exposed to a rebound in business investment spending, which may lead to their outperformance against U.S. peers.

Investors underweighted European equities in their portfolios over the last decade, and many remain underweight. Their hesitance to own Europe is understandable. The last decade in Europe feels lost. However, the result are portfolios that are more heavily weighted toward one region, such as the U.S., and less weighted toward other regions, such as Europe. The U.S.'s higher relative portfolio allocation introduces geographic and political risks, especially after its multi-year outperformance. In our view, investors will weight Europe higher in the coming months: (1) as part of the risk control aspect of portfolio rebalances and (2) if global growth and European earnings both improve.

RISKS ↘

- The coronavirus outbreak could lead to lower global growth
- European companies have struggled to keep up with their "U.S. disrupter" peers
- U.S.-EU trade & foreign policy disputes could lead to a nasty breakup

The current coronavirus outbreak represents a significant risk to European equities. The country of origin, China, is a key trading partner for Europe, especially Germany. In addition, China is the second biggest economy globally. Emerging markets tend to be tied to China growth, especially commodity-oriented countries. The longer Chinese factory lines are shut down and travel bans are in place, the lower Chinese and emerging market growth. In this scenario, Europe is likely to experience lower growth because it is more exposed to the global business cycle and growth. The risk is that European equities continue to underperform U.S. equities due to low global growth.

European companies are generally not as disruptive as their U.S. peers. Disruption and reinvesting are an important part of growing earnings. U.S. companies tend to be disruptive, which can lead to new product markets and higher earnings growth. For instance, Amazon, Uber, Google, and Tesla each have disrupted a segment of the economy. In addition, certain countries have lagged behind in terms of reinvesting in their economies. For example, Germany is intently focused on saving and running trade surpluses. German auto manufacturers ignored the threat of electric vehicles, instead opting to rig emission testing standards. The risk is that European companies' non-disruptive nature has created a competitive disadvantage against their U.S. peers in the coming decades.

U.S. and European leaders continue to battle over tax regimes and trade. A significant dispute recently emerged over a proposed EU digital services tax. The U.S. says the proposed tax unfairly targets U.S. tech companies, such as Facebook and Google. Tensions flared as the U.S. threatened tariffs against EU autos and French wine. The two sides ultimately agreed to a truce and further discussions, which has eased tensions for now. The risk is that the U.S.-EU tax/trade dispute becomes more contentious, damaging a traditionally strong relationship.



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HOW TO IMPLEMENT

There are multiple ways to structure an investment in European equities. The high-level investment thesis behind each option is the same: (1) European equities are more exposed to global growth than the U.S.; (2) the recent drop in global growth does not equal negative global growth; and (3) European equity valuations are attractive relative to their U.S. peers.

Below are three potential ways to implement European equity exposure into a portfolio:

1. Regional Exposure: Broad exposure across the entire European region is the most straightforward way to invest. This option views all of Europe as one economic region, which is generally true due to the common euro currency and economic ties of the various individual countries. Large cap focused ETFs will be more directly exposed to global growth and emerging markets. Small cap focused ETFs will also be correlated to global growth and emerging markets, but their benefit will come indirectly through exposure to large cap supply chains. Small caps also provide higher beta exposure to European economic growth.

2. Targeted Country Exposure: The European sovereign debt crisis exposed economic differences among European countries. This presents an opportunity for investors to own single name country ETFs instead of broad European exposure. Targeted country exposure provides a different risk profile due to country specific risks but is likely to benefit from a broad pickup in European earnings. Below are three European countries with additional investment catalysts:

- The United Kingdom (U.K.) voted to leave the EU during 2016. The U.K.'s internal battle to leave the EU over the past three years resulted in the country's equities trading at a discount. Now that there is a clearer Brexit path, UK equities could outperform. In addition, Ireland could benefit from the U.K.'s EU departure by becoming a post-Brexit trade route into the U.K.
- Italian equities have struggled due to the country's political dysfunction. Earlier this year, populist leader Matteo Salvini lost a regional election. Salvini's loss provides a level of support to the fragile Italian government.
- In our view, investors should be more cautious with regard to Germany. Despite the country's exposure to global growth and China, German companies have underinvested compared to their U.S. peers. German auto manufacturers ignored the threat of electric vehicles, and the German government focused on fiscal discipline over infrastructure investments. These German corporate and government decisions could put Germany at a competitive disadvantage in the coming years.

3. Sector Exposure – Financials: A targeted, more complex way to invest in Europe is to purchase regional financials. European banks continue to face business model pressures from negative interest rates. The European financial sector is beaten down, with banks cutting jobs, divesting assets, and trimming expenses. If the European economy improves, investors could rotate out of European fixed income and into equities. A move out of fixed income could pressure European interest rates, sending them higher. Higher interest rates, even if they only moved from negative to slightly positive, would benefit European banks and potentially improve investor sentiment to Europe's regional banks. In our view, this is the riskiest way to invest in Europe, but it also presents the most potential upside.



FIGURE 4

European Focused ETFs

European Focused EIRs													
Ticker	Fund	AUM (\$M)	Avg Daily Vol (3mo)	Dividend Yield	# of Holdings	Profitability (NTM EBITDA Margin)	Leverage (Debt / EBITDA)	Valuation (EV / NTM EBITDA)	Cash Flow Yield	52W Range	Performance		
											1W	6M	1Y
Broad European Equity Exposure													
Exposure Across the European Region to Large & Small Cap Stocks													
VGK	Vanguard FTSE Europe ETF	15,262	2,815,471	3.27%	1,321	17.6%	3.3x	9.0x	6.0%		-0.5%	13%	11%
EZU	iShares MSCI Eurozone ETF	5,678	3,614,584	2.83%	246	16.7%	3.7x	9.6x	5.0%		-0.5%	13%	10%
IEUR	iShares Core MSCI Europe ETF	4,301	489,778	3.27%	975	17.3%	3.2x	9.8x	5.2%		-0.5%	13%	11%
HEZU	iShares Currency Hedged MSCI Eurozone	1,024	307,426	2.67%	3	-	-	-	-		0.5%	14%	16%
IEUS	iShares MSCI Europe Small-Cap ETF	149	9,642	4.04%	978	14.7%	3.9x	10.5x	4.6%		0.2%	19%	13%
EUSC	WisdomTree Europe Hedged SmallCap Fund	81	8,066	2.98%	278	12.6%	3.8x	8.3x	5.7%		1.2%	18%	16%
DFE	WisdomTree Europe SmallCap Dividend	547	33,720	3.47%	428	10.6%	3.9x	8.4x	6.1%		-0.1%	20%	11%
Targeted Country Exposure													
Exposure to European Countries with Country-Specific Investment Catalysts													
EWU	iShares MSCI United Kingdom ETF	2,647	2,133,959	4.29%	98	18.0%	2.8x	8.2x	6.7%		-0.8%	10%	2%
EWI	iShares MSCI Italy ETF	359	769,197	3.69%	26	20.5%	4.4x	7.8x	5.7%		0.8%	18%	14%
EWG	iShares MSCI Germany ETF	2,261	2,944,171	2.50%	61	14.3%	4.7x	9.8x	5.1%		-0.9%	14%	9%
European Financials													
Exposure to European Regional Banks & Rising Interest Rates													
EUFN	iShares MSCI Europe Financials ETF	850	820,680	4.57%	83	-	7.2x	29.0x	-		-0.7%	18%	7%



Definitions

Daily Moving Average (dma): A daily moving average is an simple moving average calculated by adding the closing price of the security for a number of time periods, and then dividing this total by the same number of periods. **Overbought / Oversold (OB/OS):** OB is short for Overbought. OS is short for Oversold. Overbought (Oversold) = +1 Standard Deviation Above (Below) 50dma. **Relative Strength (14d RSI):** The relative strength index (RSI) is a technical indicator used in the analysis of financial markets. The RSI is most typically used on a 14-day timeframe, measured on a scale from 0 to 100, with high and low levels marked at 70 and 30, respectively. **EPS:** Earnings per share is the portion of a company's profit that is allocated to each outstanding share of common stock, serving as an indicator of the company's financial health. **P/E Ratio:** The price-to-earnings ratio is the ratio for valuing a company that measures its current share price relative to its EPS. **52W High / Low:** A 52-week high/low is the highest and lowest price at which a stock has traded during the previous year. **Street Rating:** The average stock rating across Wall Street in which analysts rate a stock outcome from positive to negative in the following order: Buy, Overweight, Hold, Underweight, Sell. **Basis Point (bp):** A unit of measure used in finance to describe the percentage change in the value or rate of a financial instrument. One basis point is equivalent to 0.01% (1/100th of a percent).

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