PERSPECTIVES
VIEWPOINTS FROM THE ACADIAN TEAM

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EUROPEAN EQUITIES—HAS THEIR TIME FINALLY COME?

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- European stocks are beginning to close their recent and historically unusual performance gap.
- We expect corporate earnings in Europe to outpace those in the U.S.
- Multiple catalysts, including continued implementation of labor reforms, point to reduced long-term unemployment and increased economic output.

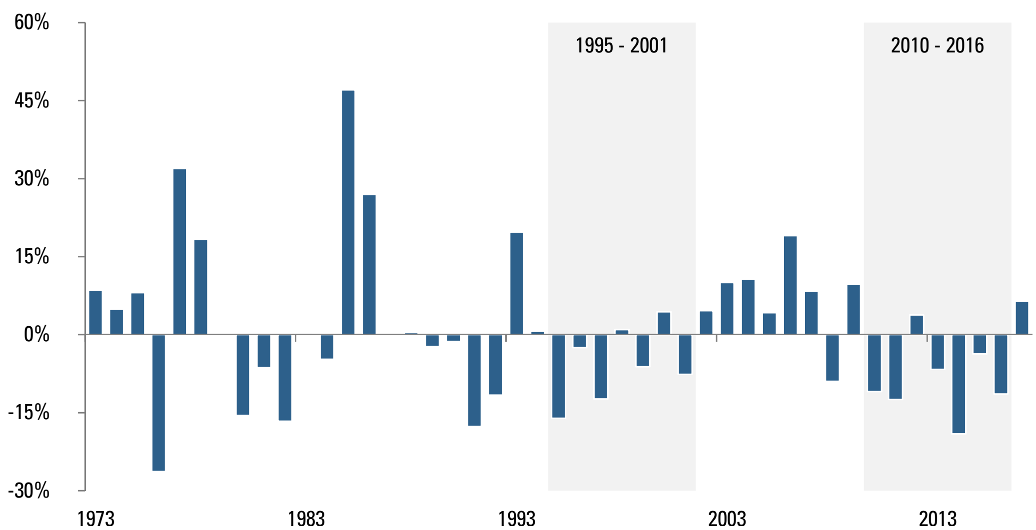
In the view of many investors, Europe has been lurching from crisis to crisis for a decade. Following the global financial crisis, Europe has faced challenges including a near default in Greece, threats of a possible break-up of the euro, and most recently Brexit, all of which have dragged on the region's economic growth and equity prices. Lately, however, indicators point to the potential for European equities to outperform those in the U.S.

RETURN HISTORY

Since 1973, returns from European and U.S. equity markets have generally kept pace with each other. Over these 44 years, Europe has outperformed in 23, or just over half the time (see Chart 1 below). However, in recent years, U.S. stocks have maintained a positive trajectory while European equities have been more volatile. For example, during the last seven calendar years the U.S. has outperformed in six. The last time we saw a similar pattern of near-consecutive outperformance of U.S. stocks was 1995-2001. Subsequently, European stocks outperformed for the next six years. Given this history, we expect closure of this more recent performance gap—and we may indeed be seeing the beginnings of this reversion with European equities outperforming the U.S. year-to-date.

CHART 1

Performance of European equities relative to U.S. equities, 1973-2017*



*MSCI Europe - MSCI USA calendar year returns in USD, gross dividends
Source: MSCI. For illustrative purposes only. Past results are no guarantee of future results. Investors have the opportunity for loss as well as profits. Index Source: MSCI. Copyright MSCI 2017. All Rights Reserved. Unpublished. PROPRIETARY TO MSCI.

VALUATIONS

Despite the similar longer-term performance of European and U.S. stocks through the years, European companies have typically traded at discounts to U.S. stocks on many valuation measures. Table 1 below shows current valuation ratios and both current and historical discounts. As of their last reported (or Fiscal Year 0) price/earnings, European stocks traded at an 11% discount which is in line with most of history. However, on measures such as price/book, Europe was trading at a deeper than normal discount. Beyond these considerable discounts, two points are worth noting. First, European stocks currently provide far more generous dividends than U.S. companies. This has advantages to investors who may not be able to easily liquidate principal. Second, expected earnings growth for the current fiscal year versus last year is considerably higher for European companies (+19%) than for those in the U.S. (+11%). Given their lower valuations, this expected additional earnings growth makes European equities all the more attractive.

CATALYSTS FOR RECOVERY

In addition to technical and valuation drivers, there are reasons to expect strong economic and market performance in Europe. Although the Bank of England has recently reduced its growth forecasts citing lower investment and spending in the face of uncertainty surrounding Brexit negotiations, there are positive signs elsewhere in Europe. Offsetting weakness in Britain are investments by financial institutions in Frankfurt, Dublin, and other cities staying within the European Union. Perhaps more important are labor reforms focusing on reducing unemployment and increasing output. Since the 1990s and early 2000s, a number of European countries have implemented policies that allow temporary employment contracts, reduce long-term unemployment benefits, and support training and placement programs. More recently, President Macron of France has made further liberalization of labor markets central to his new economic plan. The degree of labor reform still varies across Europe and can take considerable time to show material results, but the trend is clear and equity markets often respond in advance of measured economic gains. Adding to these developments is the trade surplus enjoyed by Europe. Exporters in particular will benefit from the recovery we are seeing in global economic activity.

CONCLUSION

Despite having lagged U.S. equities for several years – and perhaps in part because of it – European equities look poised to outperform. For investors considering a new or increased allocation to European equities, this appears to be an ideal time.

TABLE 1

Valuation analysis—MSCI USA and MSCI Europe

	FY0 PE	PB	PCE	Yield	FY1 PE	FY1 Earnings Growth
June 2017						
MSCI USA	21.3	3.1	14.2	2.0	19.2	11%
MSCI Europe	18.9	1.9	10.8	3.3	15.9	19%
Europe versus USA Discounts						
Current	-11%	-39%	-24%	63%	-17%	
Full Period	-9%	-25%	-24%	38%	-10%	

Source: MSCI and IBES. PB, PCE and Yield data back to January 1975, FY0 and FY1 back to January 1988. For illustrative purposes only. Past results are no guarantee of future results. Investors have the opportunity for loss as well as profits. Index Source: MSCI.

BIOGRAPHY

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Brian joined Acadian in 1990. Prior to his current role as Senior Portfolio Manager, he served as director of Portfolio Management, overseeing portfolio management policy as well as co-director of Research, responsible for developing and applying investment techniques to evaluate markets and securities. Before joining Acadian, Brian worked in systems planning at Bank of New England and as a senior systems analyst at Mars Incorporated. Brian obtained an M.S. in management from MIT and a B.S. in accounting from Lehigh University. He is a CFA charterholder and a member of CFA Society Boston.

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