LPL RESEARCH
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EUROPE COMING UP SHORT

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KEY TAKEAWAYS

When we compare Europe's economic and corporate fundamentals with those in the U.S., even factoring in valuations, we think Europe comes up short.

We continue to favor U.S. and EM equities over Europe on a tactical basis and, in general, maintain minimal allocations to European equities in our tactical model portfolios.

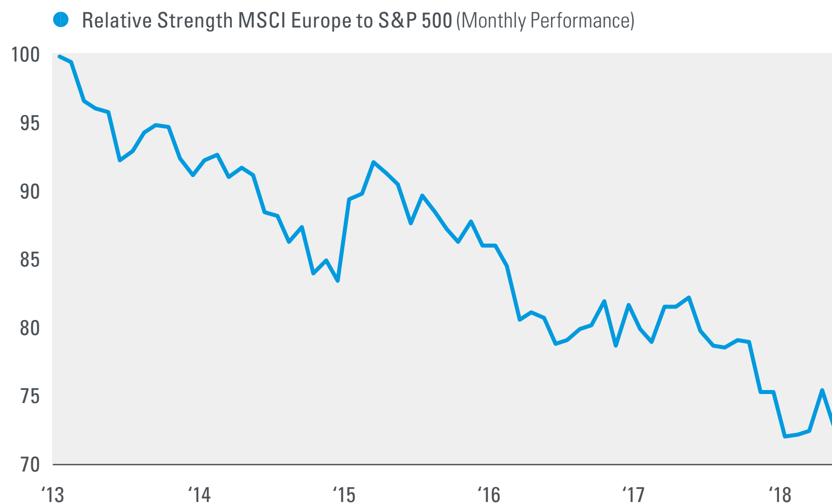
From a longer-term, strategic perspective, we still think allocating to Europe and broader developed international market equities makes sense.

Post Italy "crisis," are European stocks attractive? With last week's news that Italy has formed a government, securing the country's place in the Eurozone at least in the short term, this week we assess whether European stocks now represent an attractive opportunity. Relative to other opportunities, we don't think so, as we will explain further. Political risk in Italy has dominated headlines recently, but European economic data has also disappointed throughout the year, as earnings have softened, and European stocks have meaningfully underperformed their U.S. counterparts over the past several years [Figure 1].

QUITALY?

Stock and bond markets rebounded sharply late last week as worst-case fears related to Italy leaving the Eurozone eased. Italy formed a government that will not promote leaving the euro (or defaulting on its debt), reducing the likelihood of a Brexit-like departure from the currency union (though the United Kingdom was not a part of the euro currency union, only the trade union, i.e., the EU).

1 EUROPEAN STOCKS REMAIN IN A LONG-TERM RELATIVE DOWNTREND VS. THE U.S.



Source: LPL Research, FactSet 06/01/18

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The news helped propel the S&P 500 Index to another positive week and a solid 2.4% return in May, while the small cap Russell 2000 Index and tech-heavy Nasdaq Composite ended the week at or within a hair of record highs.

So, are Italy's and Europe's debt woes behind them? For now, it would appear so, at least in the short term. But that doesn't mean another flare-up won't come along. Italy has had nearly 90 different governments in the past 150 years and has a significant debt load ($2.3 trillion, or about 130% of gross domestic product [GDP]). The new regime is not well aligned with the European Union (EU) on economic policy or immigration, either. Competing with the core of the Eurozone (primarily Germany) with a still relatively strong euro has proven difficult (a weaker currency helps make a country's exports cheaper, all else equal). Sentiment has been damaged in the Eurozone's third-largest economy, which could be apparent in near-term Eurozone data. Finally, the European Central Bank (ECB) can't keep buying Italian bonds indefinitely to keep yields low.

We are encouraged by Italy's more secure place in the Eurozone, and a potentially weaker euro may provide some relief for exporters; however, our concerns about the structure of the currency union remain.

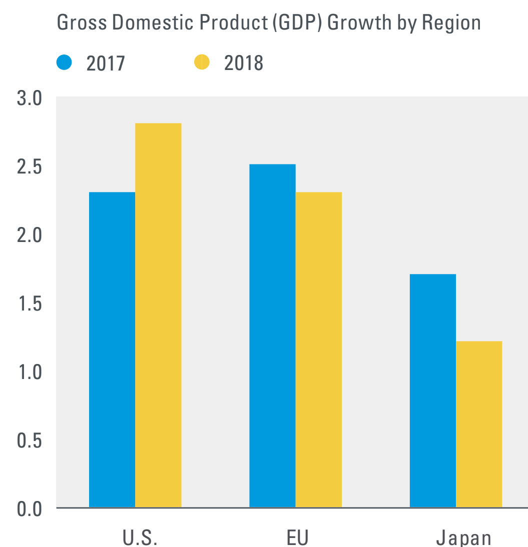
ECONOMIC MOMENTUM WANING

Political clouds may be clearing in the Eurozone, but the performance of the European economy this year relative to the U.S. makes it difficult to make a case for European equities over the U.S. (despite lower valuations and the benefits of diversification over time, which we fully believe in).

The European economy performed well overall in 2017, delivering GDP growth at a 2.5% pace, faster than the 2.3% growth rate for the U.S. economy. But the script is flipping this year, as the U.S. economy is expected to pick up speed and grow 2.8% (Bloomberg consensus), compared with 2.3% in the EU [Figure 2]. European bulls might say growth in Europe was depressed during the first quarter due to one-off factors (weather and labor strikes, primarily) and is poised to rebound. But U.S. growth was also depressed in the first quarter (which is historically the case), and the expected rebound is stronger. Based on the high frequency at which European economic data have been missing expectations over the past several months, we see some downside risk to the 2.3% consensus GDP growth forecast for 2018. The U.S. trajectory looks better.

Manufacturing had been a bright spot in Europe as purchasing manager surveys were solidly expansionary in 2017, but have fallen off in recent months; in fact, the Eurozone Manufacturing PMI for May fell to its lowest level in over a year. Conversely, U.S. measures of manufacturing are stronger and holding firm, though we acknowledge that U.S. trade policy remains a risk to growth globally.

2 ECONOMIC GROWTH IN EUROPE IS SLOWING



Source: LPL Research, Bloomberg 06/01/18

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The upside scenario is that a weaker euro helps boost trade for European exporters. We are wary of relying on that alone to build a bull case, particularly given Europe is still dependent on monetary policy while the U.S. economy has transitioned to fiscal leadership.

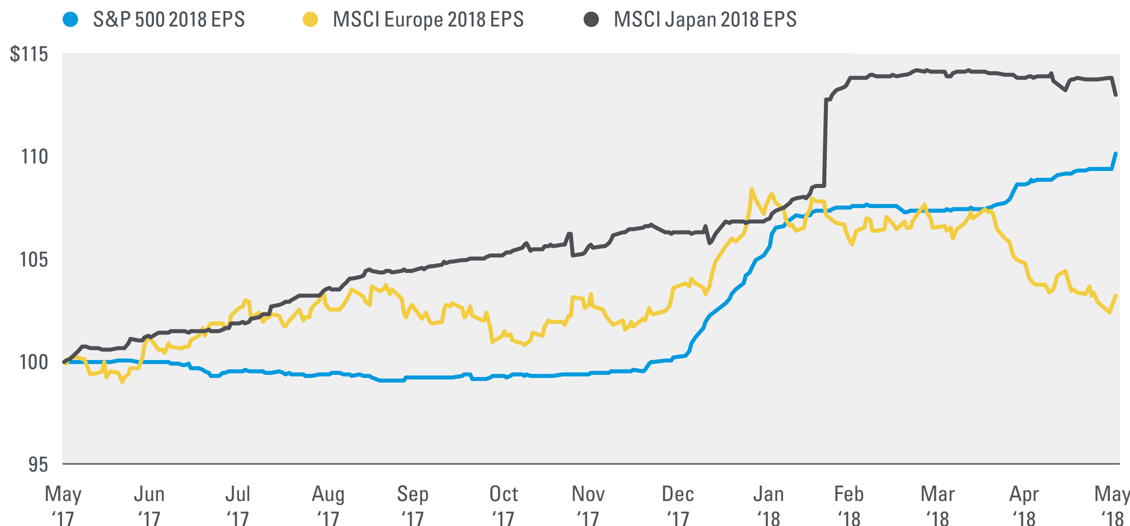
WEAKENING EUROPEAN EARNINGS OUTLOOK

Similarly to economic momentum, after strong earnings momentum in 2017, European earnings growth has also started to wane in recent months. Here again, Europe comes up short relative to the U.S. (we Americans unfortunately cannot say the same regarding soccer as the World Cup approaches).

Earnings growth is much stronger in the U.S., even without the impact of the tax cuts. Excluding the tax impact, the S&P 500 is still expected to produce low-teens earnings growth in 2018 (all-in consensus including the tax benefit is 20%). For Europe, the expectation is a much slower 6%, so the U.S. is expected to offer much better earnings growth potential.

The U.S. also offers better earnings momentum based on revisions. Figure 3 shows 2018 earnings-per-share estimates for the S&P 500 compared with Europe (MSCI Europe Index) and Japan (MSCI Japan Index). We included the largest developed markets here, leaving emerging markets out, although they compare favorably as we discussed here. You can see that 2018 consensus earnings estimates for the U.S. have been rising, while estimates in Europe

3 EUROPEAN EARNINGS EXPECTATIONS HAVE FALLEN



Source: LPL Research, FactSet 06/01/18

EPS – Earnings Per Share

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have been falling. Though not the focus of this commentary, it is notable that Japanese earnings estimates have also been rising nicely.

Bottom line, the U.S. is enjoying better earnings growth and earnings momentum.

ARE EUROPEAN STOCKS ON SALE?

There are plenty of European goods that U.S. shoppers would buy if they were on sale at 10% or 20% off. But we would argue that European stocks offer something closer to everyday low prices, so investors should be mindful that the discount on European stocks relative to the U.S. is not as big as it has been historically.

Here are the numbers to back that up. Since 1995, the MSCI Europe Index has, on average, traded at a forward price-to-earnings (PE) ratio of 12.5. Despite recent weakness, as of May 31, the MSCI Europe Index was trading at a 13.9 PE, or 11% above its 23-year average. The S&P 500 forward PE, on the other hand, stood at 16.2 at month end, matching its post-1995 average (16.1). So Europe is slightly more expensive than it has been in recent decades, while the U.S. is in line, suggesting European stocks are not attractively valued relative to the U.S.

Looking at it another way, European stocks have historically traded at a 23% discount to the U.S. on a forward PE basis; now that discount is just 14%. Add to that slower earnings growth and we see better value in the U.S.

CONCLUSION

Italy's new government is welcomed news for European and global markets. But when we compare Europe's economic and corporate fundamentals with those in the U.S., even factoring in valuations, we think Europe comes up short. Longer term, strategically, we still think allocating to Europe and broader developed international market equities makes sense, but we continue to favor U.S. and EM equities over Europe on a tactical basis and, in general, maintain minimal allocations to European equities in our tactical model portfolios. ■

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The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Investing in foreign securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

Tactical allocation may involve more frequent buying and selling of assets and will tend to generate higher transaction cost. Investors should consider the tax consequences of moving positions more frequently.

All investing involves risk including loss of principal.

DEFINITIONS

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

Forward Price To Earnings is a measure of the price-to-earnings ratio (P/E) using forecasted earnings for the P/E calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there is still benefit in estimated P/E analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

The MSCI Europe Index is a free-float-adjusted, market capitalization-weighted index that is designed to measure the equity market performance of the developed markets in Europe.

The MSCI Japan Index is a free-float-adjusted, market capitalization-weighted index that is designed to track the equity market performance of Japanese securities listed on Tokyo Stock Exchange, Osaka Stock Exchange, JASDAQ, and Nagoya Stock Exchange.

The MSCI All Country World Index is an unmanaged, free-float-adjusted, market capitalization-weighted index composed of stocks of companies located in countries throughout the world. It is designed to measure equity market performance in global developed and emerging markets. The index includes reinvestment of dividends, net of foreign withholding taxes.

The MSCI EAFE Index is made up of approximately 1,045 equity securities issued by companies located in 19 countries and listed on the stock exchanges of Europe, Australia, and the Far East. All values are expressed in U.S. dollars. Past performance is no guarantee of future results.

The Russell 2000 Index is an unmanaged index generally representative of the 2,000 smallest companies in the Russell Index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index.

The NASDAQ Composite Index measures all NASDAQ domestic and non-U.S.-based common stocks listed on the NASDAQ stock market. The index is market-value weighted. This means that each company's security affects the index in proportion to its market value. The market value, the last sale price multiplied by total shares outstanding, is calculated throughout the trading day, and is related to the total value of the Index. It is not possible to invest directly in an index.

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