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STRONG EUROPEAN EARNINGS ARE KEEPING EUROPE CHEAP

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KEY TAKEAWAYS

After years of disappointment, European earnings have been solid.

Stronger earnings may have changed the valuation equation with respect to global asset allocation.

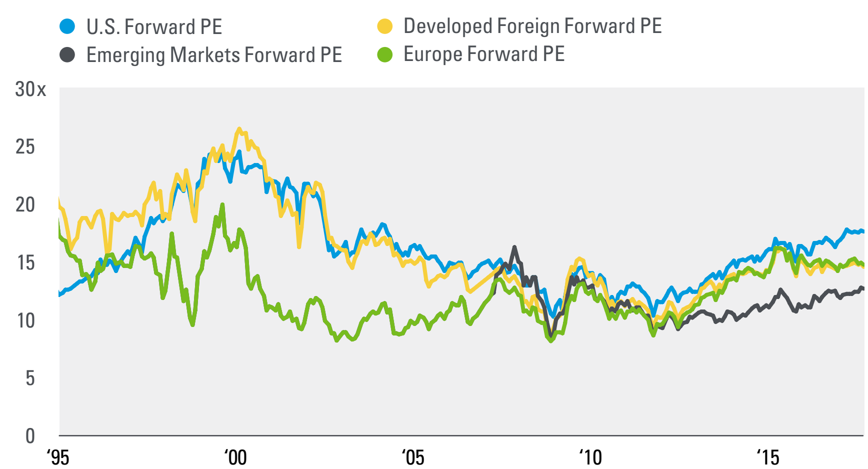
Currency still matters, both for corporate earnings as well as for translation into dollars for U.S. investors.

After years of diminished earnings ended in the third quarter of 2016, European companies have begun seeing sustained growth in their bottom lines. Ultimately, earnings drive stock prices, but the market is always trying to look forward; having strong earnings is not enough if the growth is fully priced in. That is the fundamental question with regard to stock market valuation—what are you paying for future earnings? Solid earnings in Europe are keeping price-to-earnings ratios (PE) static, while PEs on domestic stocks have been rising. This makes European equities increasingly attractive; however, currency remains a concern, as much of the recent performance of European stocks has been due to a strong euro relative to the dollar.

IT'S WHAT YOU PAY THAT COUNTS

Two things determine stock prices: how much money a company earns, and the multiple of those earnings investors are willing to pay, i.e. the PE ratio. When we

1 STRONG EARNINGS SUPPORT EUROPEAN VALUATIONS



Source: LPL Research, FactSet 09/08/17

Indexes: S&P 500, MSCI EAFE, MSCI EM, MSCI Europe

The price-to-earnings (PE) 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.

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

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

consider international investments, we have to be careful when comparing the PE ratio of one country's or region's stock market to another. For any number of reasons, some countries could systematically trade at higher or lower valuations than others. From the early 2000s until the beginning of the Great Recession, European stocks were consistently cheaper than U.S. stocks based on their PE ratio [Figure 1]. As the economy and financial markets recovered, U.S. and European stocks begun trading at nearly the same valuation.

More recently, a different dynamic has surfaced within the United States. U.S. stocks, as represented by the S&P 500 Index, have become more expensive; that is, the aggregate price of domestic stocks has increased faster than their earnings. That has not been the case with European equities, whose valuations have been essentially unchanged for the past two years. More importantly, the PE has been stable for the right reason—earnings have been increasing. During the past 12 months (through August 31, 2017), earnings for European companies have increased over 25%, with further earnings growth expected for the rest of this year.

HOW YOU PAY COUNTS AS WELL

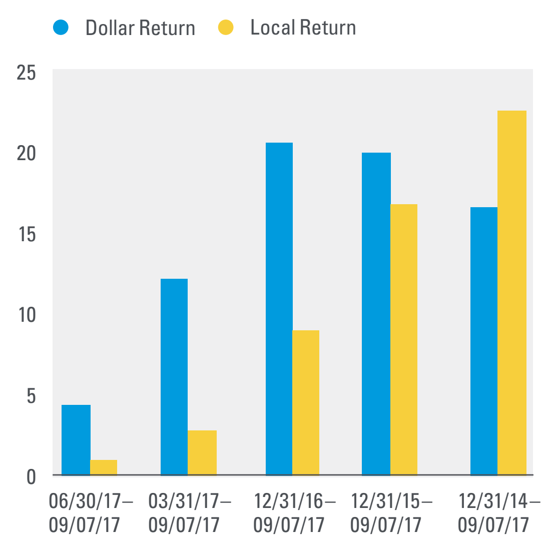
Some observers may note that European stocks appear strong this year and wonder if they missed the rally. But we don't think so because the real rally has not been in European stocks, but in European currencies, particularly the euro. When we look at the returns on European equities for investors in Europe who do not benefit from the changes in currency, returns are less impressive [Figure 2]. In fact, they have been less than 9% year-to-date in local currency. On the positive side, this is why we are not seeing valuations increase in Europe—the performance has been driven as much by the currency and it has by strong earnings.

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

Though it clearly benefits those who invest in a non-native currency to have that currency appreciate, there is also a potential downside. One is that the currency market could reverse, and what had been adding to underlying stock returns becomes a detractor.

Another fear, one that was expressed during the European Central Bank's meeting on July 20, 2017, is that the strong euro may be eroding the competitiveness of European companies. When a company resides in a country with a currency that is too strong, it may suffer when competing against companies from weaker currency countries. It is estimated that on average about 50% of European companies' sales come from outside of Europe. So while the rising euro has benefited U.S. investors in Europe, the euro's strength may hinder the profit growth that makes investing in the region so attractive in the first place.

2 EUROPEAN PERFORMANCE DRIVEN BY WEAK DOLLAR



Source: LPL Research, Bloomberg 09/08/17

Return is total return of MSCI Europe Index, annualized for periods greater than one year.

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DOES EAFE COUNT ANYMORE?

According to Figure 1, in the late 1990s there was a great difference in the PE ratio of the MSCI EAFE and Europe indexes, and these two essentially converged over time. For most investors, the EAFE Index, which stands for Europe, Australasia, and the Far East, is the primary benchmark for developed market international investing. In practice, this index is made up of over 60% European and 23% Japanese stocks. In the late 1980s these percentages were nearly reversed; however, the Japanese stock market peaked on December 29, 1989, and is still down some 50% since then. We believe that investors making tactical asset allocation decisions should consider focusing on these regions separately, and not necessarily combine them into one all-encompassing asset class.

CONCLUSION

The improvement in earnings and valuations is causing us to warm up on European equities. However, there remains real risk. Currency markets can be volatile, and the gains made by currency this year can reverse just as quickly. We don't expect that to happen, but we are always more cautious when recommending international investments and need to have relatively high conviction that there is some additional reward to compensate for taking the additional risk. When looking at Europe, we see several positives, including an improving economy, good earnings growth, and the recent success of mainstream political movements relative to more extreme movements on the right and the left. However, the region still has vast political challenges, including Brexit, as well as the anticipation of change in monetary policy, that still warrant a degree of caution. ■

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 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.

The MSCI Emerging Markets Index captures large and mid cap representation across 23 emerging markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. 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.

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