CB FONDER

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"MAGA is MEGA"

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Make America Great Again (MAGA)
→ Make Europe Great Again (MEGA)

The last decade is a lost decade for those that invested in Europe. The election of Donald Trump in the US can change that – Make America Great Again may, paradoxically, lead to Make Europe Great Again. The US is already "great" – it is Europe that needs to be "great again". We see a number of reasons why that may happen: 1) The starting point, 2) Interest rates, 3) Currencies and 4) Perception.

1) The starting point

The last decade is a lost decade for those who invested in Europe, especially for USD-investors: 100 USD invested in MSCI Europe Net on January 31 2007 would today be worth about 106 USD (Figure 1). This corresponds to an annual return of 0.6%. That is hardly "great".

MSCI Europe Net, 10 years in USD

Figure 1. The graph shows the performance of MSCI Europe Net over the last 10 years. Source: MSCI, CB Fonder

It becomes even worse for Europe in comparison to the US: never before (with data from 1969) has Europe underperformed more than the current 50% against the US, and never before has the underperformance lasted as long as the current 111 months (Figure 2 and Table 1). However, when Europe starts to outperform against the US the performance has been strong in absolute numbers too (in USD): +76% 1976-1978, +283% 1985-1990 and +102% 1999-2007.

MSCI Europe relative to MSCI USA. Periods of out- and underperformance

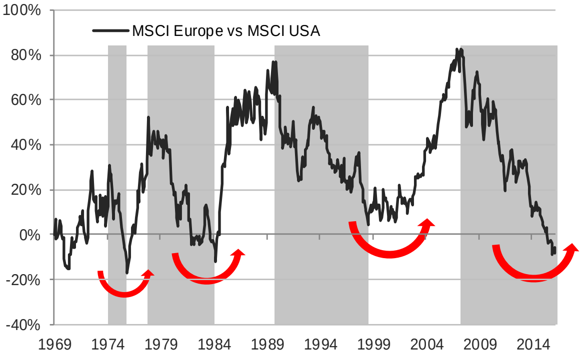

Figure 2. The graph shows how MSCI Europe has performed relative to MSCI USA since 1969 (grey areas are periods of underperformance for Europe). Source: MSCI, CB Fonder

Table 1. The table shows the same data as in Figure 2, but broken down into periods of out- and underperformance for Europe. Source: MSCI, CB Fonder

Time period		Absolute return (USD)			
From	To	MSCI Europe	MSCI USA	Relative return	Duration Months
1975-02-28	1976-10-29	-18%	30%	-37%	20
1976-10-29	1978-10-31	76%	-4%	84%	24
1978-10-31	1985-02-28	34%	132%	-42%	76
1985-02-28	1990-10-31	283%	90%	102%	68
1990-10-31	1999-06-30	224%	451%	-41%	104
1999-06-30	2007-11-30	102%	15%	75%	101
2007-11-30	2017-02-15	-8%	84%	-50%	111

Thus, the starting point is very low for Europe – and low expectations are often a good starting point since it is reflected in the valuation. Europe trades today at barely 15x the expected earnings in 12 months while the US is trading at roughly 17x (Figure 3). US is priced for perfection; Europe may surprise on the upside.

Valuation gap – 12 month forward-looking P/E-ratios

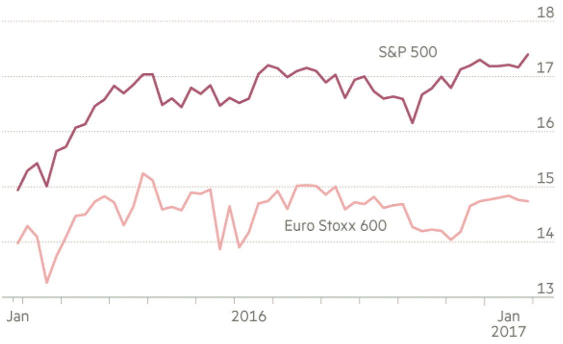

Figure 3. S&P 500 trades today at roughly 17x the expected earnings in 12 months; ditto for Euro Stoxx 600 is barely 15x. Source: FT

2) Interest Rates

To conduct an expansionary fiscal policy in a booming economy is very unorthodox and will result in rising inflation and interest rates in the US – which was the trend even before Donald Trump. The Fed has raised its rate twice since the low-point in December 2015 and will probably raise another 2-3 times during 2017. The market has already started to move by pushing up the US 10-year yield from 1.4% in July 2016 to 2.4% today. We believe that rates are still too low and that the rising trend will continue.

The aggressive fiscal policy in the US will spread to Europe triggered by the risk of a more protectionist US economy and pressure from populist movements in Europe. Germany – which has opposed a more expansive fiscal policy – now have good reasons to change its view (Figure 4). Increased military expenditures is the beginning of a more aggressive fiscal policy in Europe.

Germany is the biggest loser of increased protectionism – fiscal policy may compensate for that

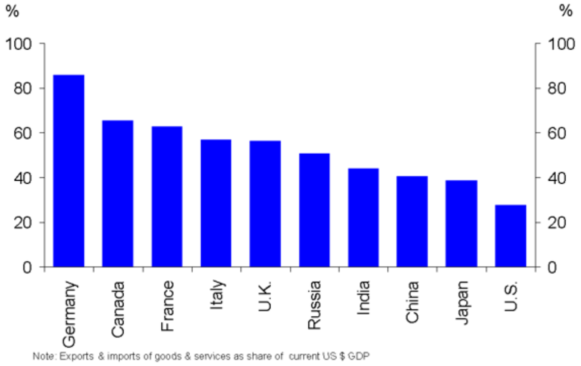

Figure 4. Share of GDP from international trade, which for Germany is almost 90%. A more expansive fiscal policy may stimulate domestic consumption and compensate for a decrease in international trade. Source: Deutsche Bank Research

The shift from monetary policy to fiscal policy will result in rising interest rates in Europe as well, which has historically benefited Europe relative to the US (Figure 5 and 6). Rising interest rates benefits Value stocks, and when Value has outperformed Growth – which has been the case since July 2016 – Europe tend to follow and outperform the US.

Europe outperforms the US when Value outperforms Growth

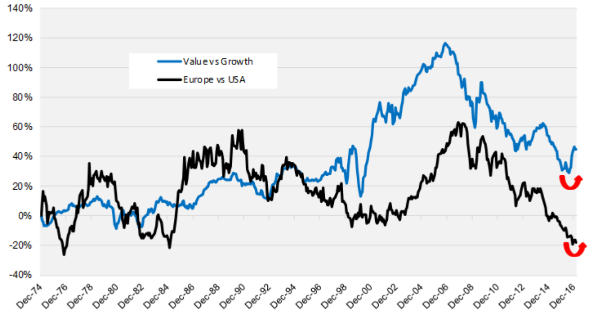

Figure 5. A trend reversal in favor of value stocks compared to growth stocks has historically been a positive sign for Europe relative to the US. This connection has been strong the last 20 years. Source: MSCI, CB Fonder

Underweight US stocks when cyclical stocks outperform defensive stocks

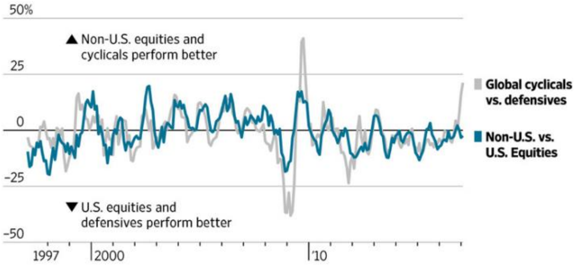

Figure 6. Cyclical stocks have outperformed against defensive stocks (grey line) – this has historically been associated with underperformance for US stocks. Source: The Wall Street Journal

3) Currencies

The USD is strong and has strengthened further since the election of Donald Trump, which has made an export dependent Europe (Figure 7) more competitive. The American labour market in full employment with wage inflation around 2% should lead to continued rate hikes by the Fed. Meanwhile, the ECB continues to pump liquidity into the market (Figure 8). This divergence between the central banks should result in a continued strong USD against EUR, at the same time as a strong US economy increases the demand for European exports.

In time Trump's protectionism might become reality, which would be negative for many/all countries, but as of now the US does not have the production capacity needed to supply the domestic market with American goods only (the majority of the "Make America Great Again" hats are produced outside of the US…)

Europe is the most export dependent – US the least

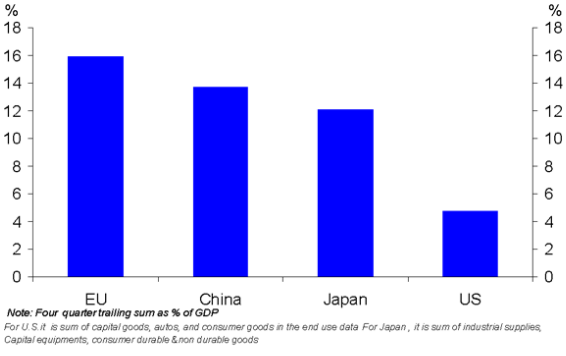

Figure 7. Share of GDP from manufacturing exports, as of Q3 2016. Source: DB Global Markets Research

ECB's bond purchases depreciate the value of the EUR

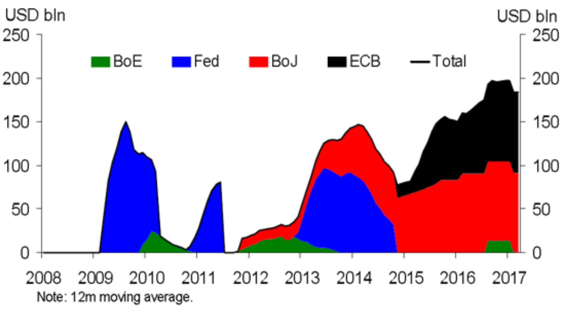

Figure 8. Monthly government bond purchases by the Fed, ECB, BoE and BoJ. Source: DB Global Markets Research

4) Perception

The view that Europe's economy is suffering is being increasingly contradicted by data: The eurozone has experienced 14 quarters of continuous growth, unemployment is down to single digit, PMI for the manufacturing industry is on a six-year high (a leading indicator, Figure 9) and earnings growth for 2017 looks to be almost 15% after five years of negative or zero growth (Figure 10). In other words, the economy has been suffering but is now doing quite good. The perception that Europe has stagnated and been left behind still remains, especially compared to the US.

In fact, the GDP growth in the eurozone in 2016 was higher than the growth in the US (1.7% vs 1.6%) and it is the estimates for 2017 for Europe that are being revised upwards the most, according to Focus Economics. Even for 2018 – when Trump's tax cuts and infrastructure investments are expected to have the most effect – the expectations for Europe are revised upwards in the same pace as those for the US.

It is about expectations, and expectations for Europe are low after a lost decade. For the US they are high. The trigger for Europe is MAGA – that is MEGA!

PMI, a leading indicator, signals accelerating growth in the eurozone

Figure 9. PMI for the manufacturing industry in the eurozone (blue line, left axis) is trending upwards, which is a good sign for GDP growth (red line, right axis). Source: DB Global Markets Research

Changes in earnings growth estimates 2012-2017

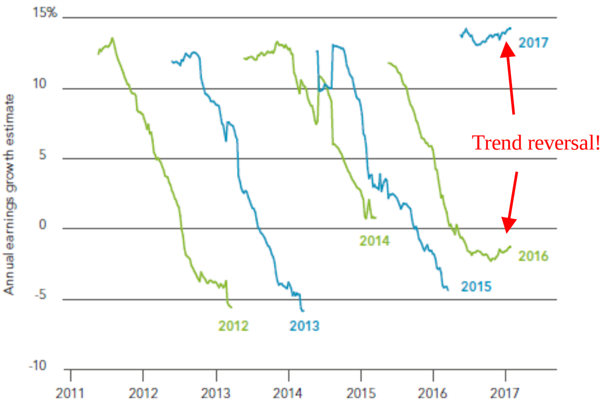

Figure 10. The curves show how the analysts' earnings growth estimates for each calendar year changed during the year; for 2012-2016 the expectations were roughly 10% at the start of the year, but the actual outcome was negative or zero. The expectation for 2017 is almost 15% - and trending upwards. Source: BlackRock Investment Institute

Populism – threat or opportunity

Populists in Europe are expected to receive a lot of votes in the elections in Netherlands, France and Germany. This creates uncertainty and is holding back the stock market, even though the overall trend is positive.

The market is primarily driven by other factors than politics in the short term, especially in a ”bull market”. The market recovered from Brexit in a week, from Trump in an hour and from the referendum in Italy in a minute – every election that ”went wrong” has this far been an opportunity to buy. Controversial as it may be, a ”moderate” influx of populism may prove to be a tailwind for European stock markets: over-regulation has in many aspects limited Europe’s full potential over the last decade. The political winds of deregulation (Trump and Brexit) might prove relatively beneficial for an over-regulated Europe.

However, it should not go too far; too much or too little ruins everything and history has taught the EU – which is a successful peace project – not to experiment too much. With Putin in the east, Trump in the west and Brexit on the home turf, it’s “now or never” for Europe!