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The Marshall Plan 2.0 – Welcome back, Europe

Since the financial crisis, Europe has in many aspects struggled to recover. However, there are reasons to be optimistic about the future. In addition to ECB's announced quantitative easing, we have identified a number of reasons – both technical and fundamental – that support our belief of a relatively strong European market going forward.

"For European recovery – supplied by the United States of America" read the label of the Marshall Plan nearly 70 years ago. Now it's time for Europe to rise once more. The US has, since the beginning of the financial crisis, outperformed Europe both in terms of economic growth and stock market performance. Figure 1 shows the performance of MSCI Europe against MSCI USA since 1969; Europe tend to perform better than the US over time, but has underperformed significantly during four periods: 1975-1976; 1978-1985; 1990-1999; and 2007-2014 (grey areas, Figure 1).

MSCI Europe relative to MSCI USA

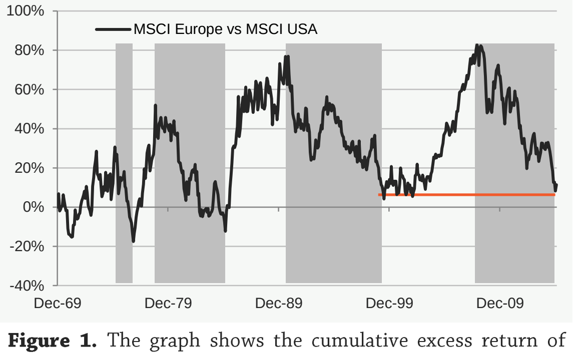

Figure 1. The graph shows the cumulative excess return of MSCI Europe Net relative to MSCI USA Net. Today's scenario is interesting partly because Europe is at the support levels from 2000 and partly because Europe has underperformed the US by roughly 40 percent since 2007, which is in line with the maximum underperformance of MSCI Europe relative to MSCI USA during previous periods of underperformance (see Table 1). Source: MSCI, CB Fonder

Common to the four periods is that Europe's underperformance relative to the US has always found a bottom at around 40 percent underperformance. Our take of a bottom for Europe relative to the US is reinforced by the fact that MSCI Europe relative to MSCI USA is at the support level from the turn of the millennium (red line, Figure 1).

Another important finding from Figure 1/Table 1 is that the turn after the three previous periods of strong underperformance has been characterized by periods of strong outperformance for Europe relative to the US; after the 1975-1976 period, Europe outperformed the US by 84 percent in 24 months; after the 1978-1985 period we saw outperformance by 102 percent in 68 months; and after the 1990-1999 period, 75 percent in 101 months.

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

Table 1. The table is based on the same data as Figure 1 and illustrates each separate period of out- and underperformance of Europe against the US. Source: MSCI, CB Fonder.

Time period		Absolute return, USD		
From	To	MSCI Europe	MSCI USA	Relative return
1975-02-28	1976-10-29	-18%	30%	-37%
1976-10-29	1978-10-31	76%	-4%	84%
1978-10-31	1985-02-28	34%	132%	-42%
1985-02-28	1990-10-31	283%	90%	102%
1990-10-31	1999-06-30	224%	451%	-41%
1999-06-30	2007-11-30	102%	15%	75%
2007-11-30	2014-12-31	-8%	56%	-41%

Thus, from a technical perspective, Europe has a bright future ahead. From a fundamental perspective, we see three main reasons why the sun will rise over Europe once again: 1) external shocks, 2) mean reversion, and 3) valuation.

1) External shocks – EUR/USD and the oil price = The Marshall Plan 2.0

Over the past eight months, the euro has depreciated by about 19% against the US dollar and the oil price has fallen around 50% – tailwinds for Europe and something to thank the US for; shale oil in the US has led to an energy revolution that has brought down the oil price, while the strong and persistent economic recovery in the US has made the US dollar appreciate against the euro.

Europe is starting to benefit from lower oil prices and a weakening euro

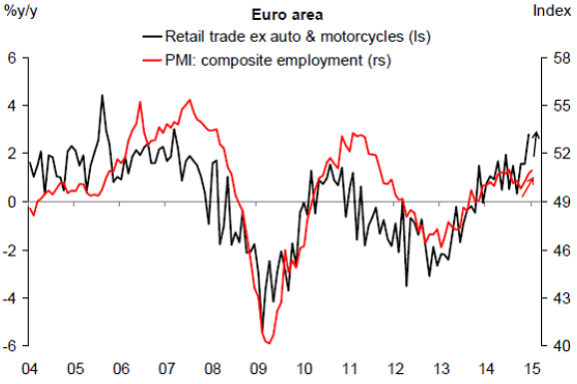

Figure 2. A weak euro and a low oil price is favorable for Europe, which is evident from rising exports and increasing retail sales. Source: Deutsche Bank Research

The first evidence that these market movements are having an impact on actual data is illustrated in Figure 2 above, which shows the PMI (red line) and the annual growth of retail sales (black line). In addition to retail sales – that benefit from higher disposable income as a result of a falling oil price; practically a tax cut – we argue that European exporters in general, and German exporters in particular, are big winners, as reflected in the rising PMI. Moreover, we find it possible that the euro may reach parity with the US dollar during 2015 and in such a scenario the consensus earnings estimates for, e.g., the German export-intensive car manufacturers can be revised upwards by as much as 10% for 2015 and 20% for 2016 relative to current levels. That, if anything, is earnings estimates momentum and a good indicator of rising share prices.

2) Mean reversion – this time is not different

A common assumption that often follows from long, but in the end finite, trends is that "this time is different", such as the assumption of "decoupling" and the super-cycle (regarding a stock market that cannot go down) which were used frequently during the market peak in 2007. Now, when the US stock market has outperformed the European for seven years, the new truth is that the US has "decoupled" from Europe. It is possible that this is the case – that this time is different – but the long-term trends tell a different story.

First of all, US and European companies' profit margins have over time been highly correlated, even though far from perfectly correlated over shorter time horizons. As Figure 3 illustrates, rising and falling profit margins in the US has historically been followed by the same development in Europe, and the margins have converged on a recurring basis. Figure 3 shows this relation since 1990 as well as the fact that the profit margins in the US are near all-time highs while those in Europe are at relatively low levels, causing extreme differences in profit margins between the US and Europe.

Profit margins in Europe and the US – gap at record levels

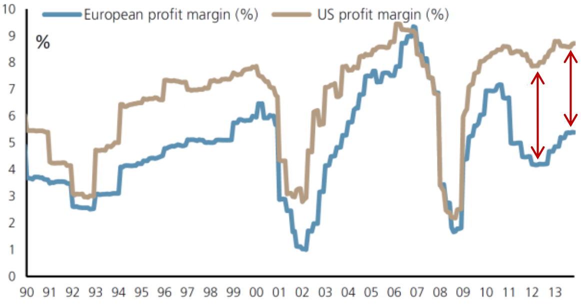

Figure 3. The profit margins in the US are near all-time highs while ditto in Europe are at relatively low levels, causing extreme differences in profit margins between the US and Europe. Source: UBS Investment Research

The long-term profit trend – a variable depending on aggregated profit margins and aggregated turnover – tend to be a reasonably reliable variable to forecast the aggregated earnings long-term; in the short-term, however, large deviations might occur, in similarity with the profit margins. Figure 4 and 5 illustrate this with the case of Europe and the US since 1980; the US has returned to the long-term profit trend, while we are still waiting for Europe to get back on track – more specifically, the aggregated profits in Europe need to rise 46% in order to return to trend.

American and European profit growth vs. long-term trend

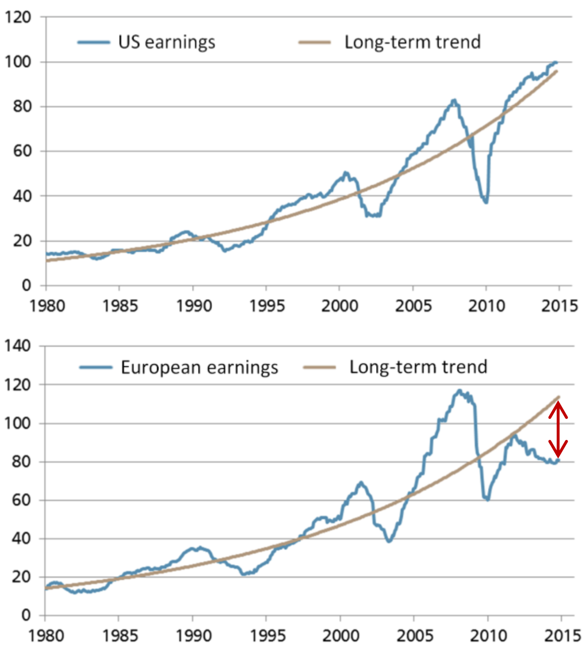

Figure 4 & 5. The aggregated profits in Europe must rise considerably if they are to return to the historical trend and catch up with the earnings in the US, which are in line with the long-term trend. Source: UBS Investment Research, CB Fonder

3) Valuation – the price matters

"Everything is expensive!" as many point out, and rightfully so – but also less so, depending on your point of view. We begin with the absolute truth, i.e. the valuation in absolute terms. The cyclically adjusted P/E ratio CAPE, or Shiller P/E, has historically been a reliable variable to asses the stock markets long-term development; the lower value of today's CAPE, the higher long-term return. Unlike the "normal" P/E ratio – based on the volatile profits for the past 12 months or the expected profits the coming 12 months – CAPE sets the current price in relation to the average, and less cyclically dependent, earnings for the past 10 years. The variable is reliable in the sense that the historical relationship between CAPE and long-term return is strong, while the relationship between the "normal" P/E ratio and the short term return is non-existent. Figure 6 and 7 illustrate this by, in Figure 6, showing that the CAPE for Europe is historically low (barely 16x compared to the long-term average of roughly 20x) and in Figure 7 by illustrating that the historical relationship between CAPE and the future stock price development is strong (the coefficient of determination, R^2, equals 0.7), and that the current CAPE has historically been a strong indicator for good long-term returns. In plain language: buying European stocks today will, given the historical relationship between CAPE and return, yield an annual return of just about 15% over the next 10 years or roughly 300% in total. Historically, the model has been able to explain 70% of the total return, which can be both higher and lower than the model predicts.

CAPE for MSCI Europe is at historically low levels

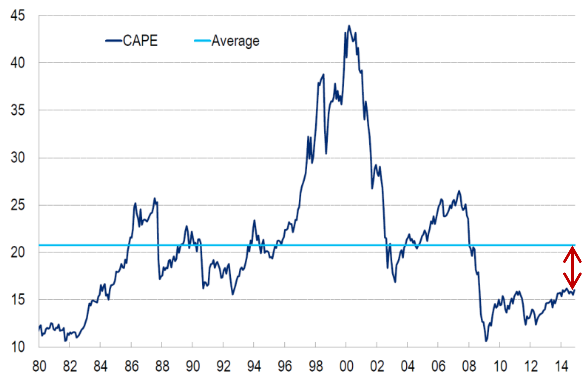

Figure 6. The graph shows that the CAPE for Europe is historically low, barely 16x compared to the long-term average of roughly 20x. Source: Citi Research

Strong relationship between CAPE and future returns for MSCI Europe

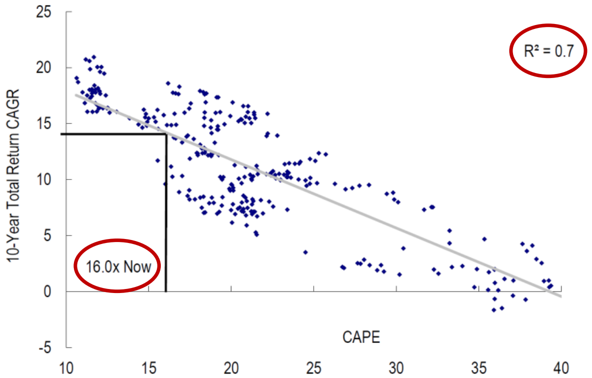

Figure 7. The graph shows that the historical relationship between CAPE and future stock market return is strong for MSCI Europe (R^2 = 0.7). The current CAPE has historically indicated an annual return of about 15% the next 10 years or 300% in total. Source: Citi Research

The other viewpoint, regarding whether the market is expensive, is relative, i.e. the valuation relative to the alternative – in this case: the US. The blue line in Figure 8 shows the CAPE for Europe, same as in Figure 6, but instead of measuring in absolute terms, it is measured in standard deviations from the historical mean. The brown line illustrates the same multiple for the US.

The difference in CAPE between Europe and the US is at a 30-year high

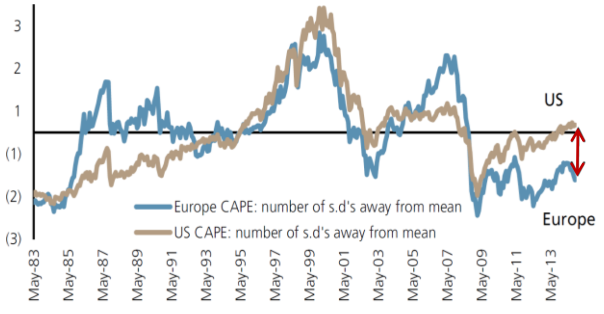

Figure 8. The graph illustrates the share price in relation to the average earnings over the past 10 years, measured in standard deviations from the historical mean. The actual values of CAPE for Europe is at about 16x and 26x for the US. European equities look cheap both compared to the historical average and compared to US equities. Source: UBS Investment Research

Three observations are evident from Figure 8, one of which already known from Figure 6: based on CAPE, European equities look historically cheap. The other two observations are: 1) US equities are, based on CAPE, slightly more expensive than the historical average (roughly ½ standard deviation more expensive; US is currently trading at CAPE 26x!), 2) US equities are historically expensive relative to European equities, or conversely: European equities have never been cheaper relative to US equities.

Conclusion

Investors who allocate between Europe and the US have rarely faced such diverse conditions as is the case today: firstly, we have US equities, which have generated an annualized EPS growth rate of 11% over the past four years, in USD, and where real GDP has grown at an annualized 2.2% – accelerating in the past six months – and where inflation/deflation is not perceived as a real threat. Secondly, we have European equities, with an annualized EPS growth rate of -1.8% over the past four years, in EUR, and where real GDP has grown at an annualized 0.3%; the economy is on the edge of deflation – even prior to the fall in the oil price. Thus, it is reasonable to state that the US stock market has outperformed the European by a large margin in recent years due to the superior growth in the US. And if one were to believe the economic forecasters, the US will continue to outperform Europe in terms of economic growth during 2015 and also thereafter – but with a CAPE of 26x for the American market, it will certainly require a lot of positive economic news to defend that valuation!

From this, our take is: not only is it risky to base investment decisions on the economic forecasters' (often inaccurate) growth forecasts, it is also essentially an erroneous approach: it is the deviation from the forecast that determines the future returns, i.e. the positive or negative surprise – which by definition is hard to predict. Investing in a market where the valuation is relatively low and where the surprises, according to us, are on the upside, has historically been a good strategy – in the same sense as contrarian bets often has proven to be.

For questions or comments, please contact us at info@cbfonder.se or call +46 8-566 133 10.