Perspective

More robust and well balanced growth justifies a reassessment of Eurozone markets!

Didier Bouvignies & Ludivine de Quincerot
Respectively General partner & CIO and Portfolio Manager & Spokeswoman at Rothschild Asset Management

As the year begins, it's time for a look back at 2017 and the outlook for 2018. Investors won't soon forget equities' steep outperformance in 2017 *vs*. bonds, against a backdrop of extremely low volatility, as this was the opposite of what most of them expected.

Some other highlights of 2017: US markets outperformed in local currency; the limited variation in interest rates in the Eurozone (widening by just 30 bp *vs*. their average level on the year); value and growth strategies performed similarly, and small caps continued their almost 10-year run of outperformance. The steep run-up in the euro made domestic investments more attractive than international ones.

Accordingly, stock-picking was the watchword in the Eurozone in 2017. In fact, in addition to mere "size", this was what truly distinguished managers from one another, for better or for worse. Early in the year the Eurozone demonstrated its resilience in overcoming numerous political issues. This was seen in the spectacular gains by those peripheral country bonds that had been hardest hit in the past, such as Portugal and Greece. Despite mid-year hand-wringing, commodities fared very well, oil in particular.

On the macroeconomic front, while US growth forecasts followed a V-shaped curve, they were ultimately rather close to the forecasts made at the begining of the year. The main surprises were the rebound of growth in Emerging markets and the Eurozone, the ongoing earnings upgrade process despite the euro's gains, and the greater-than-expected slowdown of the UK economy in the wake of the *Brexit referendum*. As a result, the global economy has gone from a situation, three years ago, when growth was moderate and poorly distributed, to more sustained and evenly balanced growth in 2015 and 2016, to robust and synchronised growth between the various geographical regions and from country to country within the Eurozone in 2017 and 2018. The pace of growth, which, over the past three years had been greater than the trend in the main economies, has accelerated recently. The consensus is that these trends will continue, driven by the 10-year high in industrial and consumer leading indicators. This growth environment, driven by greater momentum in investments and ongoing job creations, is providing some visibility and opening the door to double-digit earnings growth.

Equity investors on both sides of the Atlantic have enjoyed an almost unparalleled combination over the past four years – in the US, economic growth with no real wage pressures and an interest-rate environment that belies eight years of growth; and in Europe, ongoing quantitative easing after four years of economic recovery. This is no doubt one of the most disrupting factors of this New Year and one that constitutes a major source of opportunities and risks in asset allocation and thematic to overweight in 2018.

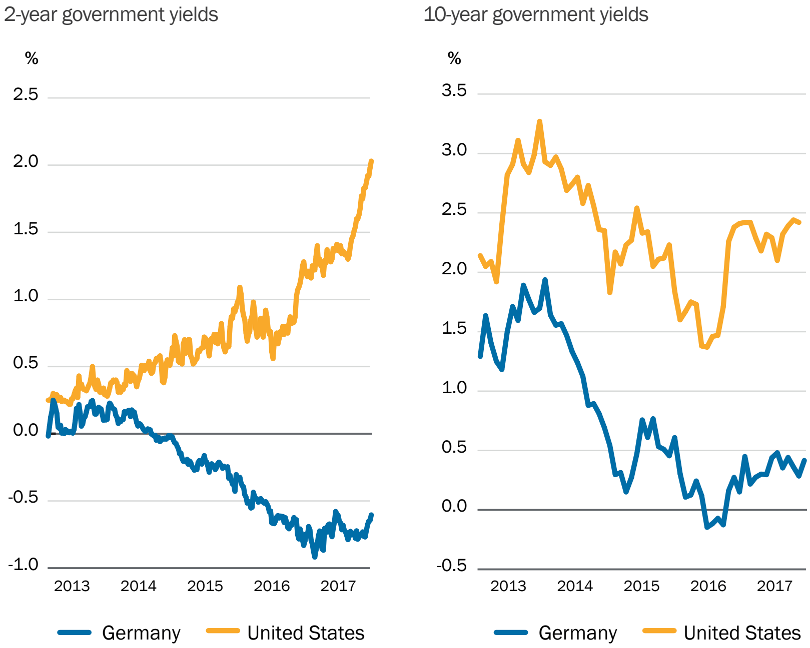
The fixed income market indeed looks risky, given the prolongation of the cycle and pressures that are beginning to build up in labour and capital production factors, inflation expectations, uncertainties on the conduct of monetary policy, producer price trends, yield spreads between the US and Europe; and a US yield curve featuring a sharp rise in the 2-year yield with no real impact on the 10-year yield. Some might object that we have been sounding the alert on the fixed income market since the end of 2014. Then again, an investment in Eurozone government bonds over the past three years has performed very poorly (a cumulative 3%), whereas other asset classes, equities in particular - with about 30% by the Euro Stoxx dividends included and 33% by the MSCI World in euro - have fared far better. So while investors haven't lost money on government bonds, they have made very little money off them and, in any case, at this point in the cycle they could become expensive. (*Cf. Fig. 1*)

"The Eurozone demonstrated its resiliency in overcoming numerous political issues and to record a comparable growth to United States on the last three years..."

Our view of trends in the cycle, which was ultimately correct, has been good news for corporate earnings momentum but did not play out in full in the sector allocations, due mainly to this inertia on the fixed income market, which is still hard to explain. Indeed, 2-year yields at -0.6% might point to new declines in ECB intervention rates, even though the ECB is trying to taper off its injections, and the real rates implied in German inflation-linked bonds at -1%, *vs.* +0.5% in the US, cannot be justified by an actual growth gap.

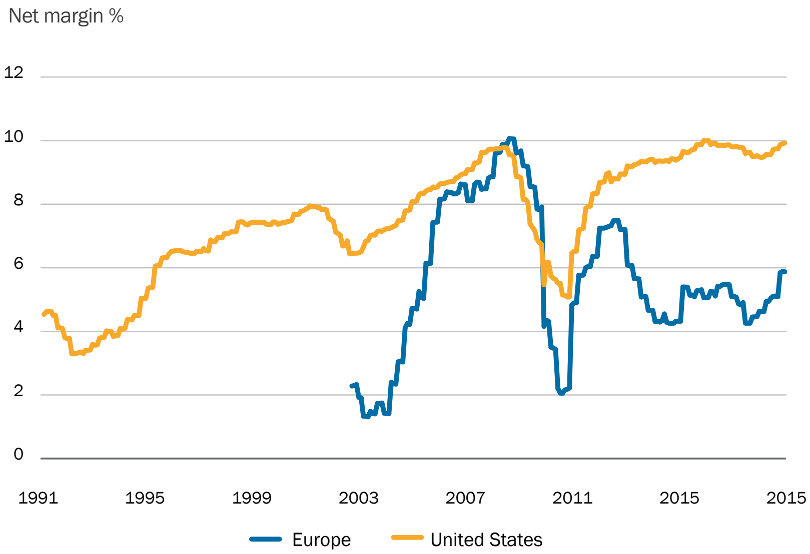
On the equity markets, US corporate profits will get a boost from tax reform, but it is hard to say by how much, given the impact of exceptional accounting restatements. European corporate profits will get a growth boost from significant productivity efforts in recent years, while Japanese companies will enjoy strong productivity, the benefits of which will flow down mainly to shareholders.

Fig. 1: Desynchronisation between the US and Europe in 2017



Sources: Thomson Reuters, Datastream, Rothschild Asset Management – 16 January 2018

Fig. 2: The US cycle: Margins higher than in 2007, unlike Europe



Source: Deutsche Bank, Rothschild Asset Management – 16 January 2018

"Upside potential for margins and no overvaluation on the Eurozone..."

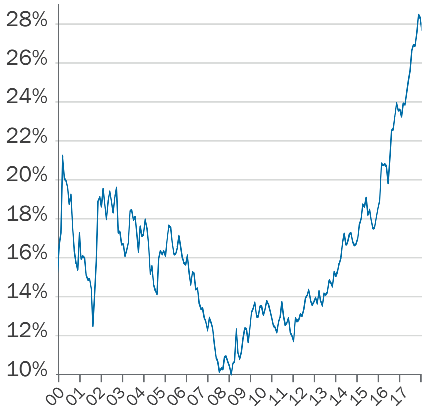
Valuations, meanwhile, are more complex than they might seem. Saying that US markets are expensive is a little too simplistic, given how crucial profitability is in assessing prices. Profitability continues to improve for listed US companies, with a 15% return on equity that is quite at odds with the historical average and even more so with the risk-free rate, and as such is a disruptive factor in the cycle. Meanwhile, a valuation at 18 times forward earnings, while slightly above the historical average, could be due to far lower interest rates than in the past. Much of this over profitability is obviously, but not exclusively, due to tech stocks, which are indeed likely to generate volatility on this market depending on the how able these companies are seen of being able to generate above-average profitability. (*Cf. Fig 2 and 3*)

In the Eurozone, however, the situation may be clearer. European companies' return on equity is about 10%, slightly below their historical average, and their valuations are at just 15 times forward earnings (the historical average), which, moreover, fails to price in ongoing improvement in profitability for more than the next twelve months. So it is clear that in the past two years, corporate earnings growth has not led to an increase in the valuation of European stocks, as seen in valuation multiples. Dividend yield, at about 2.8% is rather even from one sector to another and far higher than the government bond yield and even higher than the yields on the corporate bonds of the same companies. (*Cf. Fig 4*)

Eurozone is much less far along in the economic cycle than the US, and that gives it some room to catch up. Moreover, a correction in the abnormally low interest rates would be considered as good news, similar to what has occurred on the US market in recent years. And the lack of a GAFAM theme – Google, Amazon, Facebook, Apple, Microsoft – which has dragged down stock performance in recent years, could offer some protection if doubts were to return. Lastly, the political situation, which has generated so many concerns, is clearing up. Italian elections on 4 March, the only real electoral event on the agenda for 2018, do not look like a true threat.

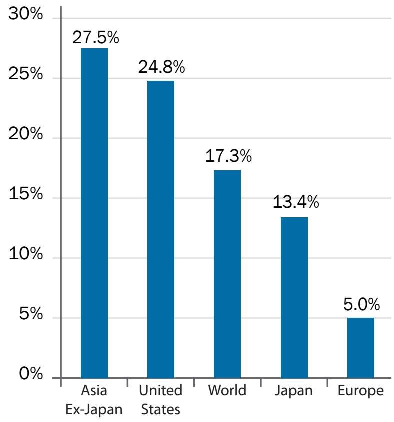
Fig. 3: Tech weightings are low in Europe

MSCI EM Index - Asia
Tech sector weigthing



Source: Bloomberg

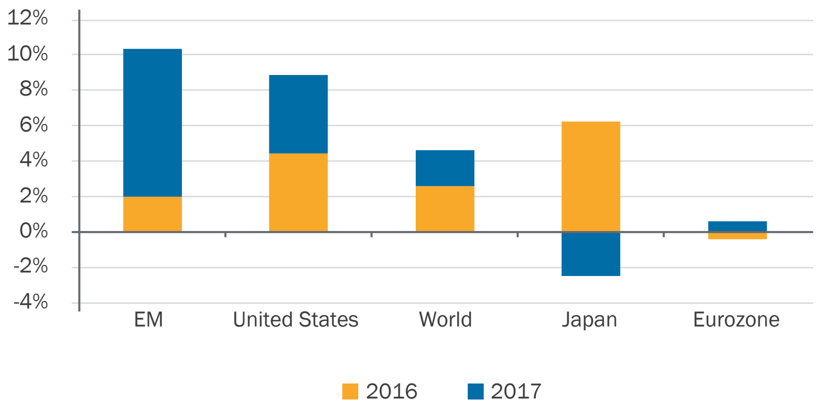
MSCI Index -
Tech stocks weight



Source: MSCI, FactSet, Goldman Sachs Global Investment Research – November 2017

Fig. 4: A European market at the same level of valuation as in 2015

P/E over the next 12 months



Source: IBES, Rothschild Asset Management – January 2018

"Our fund range performed very well in 2017, whether fixed income, equity or diversified strategies..."

As for investment flows, the heavy net redemptions on the Eurozone markets in 2016 (€100bn) were only slightly made up by the €40bn in net subscriptions in 2017. In 2018, in a appeased political climate, combined with strong M&A momentum, a potential return of foreign investors to the Eurozone in the wake of the strong performances of 2017 (enhanced by a "forex" impact that was favourable to them) is also a strong argument for the Eurozone.

As we noted in July 2017, exchange rates could give pause, especially as the Eurozone's relatively low inflation in recent years, along with the heavy current account surpluses in the rest of the world seem to justify an appreciation in the single currency but without penalising the industrial sector, as seen in corporate margins, given that the euro exceeded USD 1.40 in 2007. However, it is the pace of appreciation that we have to keep an eye on. The current level is favourable, as seen in the current account surplus amounting to 4% of GDP in the Eurozone.

Of course, we remain on high alert, given how far along the cycle is, the coming end of accommodative monetary policy, and the likely trend in interest rates. Perhaps even more with regard to the US cycle, as the global economy could have a hard time putting up with overly aggressive rate hikes. But we are not there yet.
The normalisation of Eurozone fixed income markets will be good news at first and should help the Eurozone outperform the rest of the world, driven by gains by cyclical and financial sectors, the main beneficiaries of growth and higher rates unlike growth stocks, whose valuations price in an environment of very low interest rates for some time to come. Our fund range performed very well in 2017 - whether fixed income,equity or diversified strategies - thanks to their low bond yield sensitivity, the strong showing by peripheral bonds, the outperformance by equities, and a good stock-picking. The environment that we just described points to a continuation in this trend, which could show up even more clearly in our equity portfolios if large caps were to outperform small caps.

Written by 18th January 2018

About Rothschild Asset Management
Rothschild Asset Management offers an independent perspective in innovative investment solutions, designed around the needs of each and every client. We are a global specialist asset manager delivering bespoke investment management and advisory services to institutional clients, financial intermediaries, and third party distributors. Across our complementary fields of expertise in active high-conviction management and open architecture investment solutions, our business model is grounded in deep understanding of each and every client's needs. We combine state-of-the-art technology and the latest sophisticated modelling with deep on-the-ground experience to develop bespoke investment solutions for our clients. It is this innovative yet considered approach that enables to offer a distinct perspective to our clients and make a meaningful difference to their assets in the long-term.
For more information: www.rothschildgestion.com