Kai Lam
Vice-President & Portfolio Manager

SPECIAL REPORT

Time to Go Shopping in Europe

We all know the benefits of diversification when it comes to investing — as well as the dangers of putting all of one's eggs in one basket.

But beyond deciding between which asset classes to own (i.e., stocks or bonds) and in which sectors (such as Industrials, Financials, Energy or Technology), spreading your investments across different geographic regions can provide significant rewards for your portfolio as well.

This is especially true now for North American investors, as parts of the Canadian stock market are facing challenges posed by the weakness in oil prices and U.S. equities are finding out that as difficult as it is to get on top, it is even harder to stay there.

With this in mind, it is worth turning attention to Europe — a region that has seen its economy and financial markets lag the considerable upswing seen on this side of the Atlantic over the last few years, but that now appears poised to make up for lost time.

RUNNING UPHILL AND INTO THE WIND

While the global financial crisis of 2008 wreaked havoc on economies across the world, the recovery has occurred at a much more varied pace and the euro area in particular has struggled to establish much in the way of economic momentum.

In contrast to other areas of the world that were able to institute broad fiscal stimulus plans along with aggressive cuts to interest rates in the years following the downturn, onerous debt burdens of European governments led to deficit-fighting budgets that reduced spending and raised taxes, while the European Central Bank (ECB) increased interest rates in an attempt to stem what were viewed at the time as rising price pressures — all of which served to compound the region's problems and keep Europe mired in a prolonged recession.

UNDER PRESSURE AND OUT OF FAVOUR

With such a challenging economic backdrop, it is not surprising that corporate earnings in Europe lagged significantly behind those in North America. The weak economy was exacerbated by a strong currency that made the region's exports relatively expensive, reduced the domestic value of foreign-sourced revenues and increased costs of imported capital, combined with tight credit conditions to further compress already relatively narrow profit margins.

SUMMARY

- Spreading your investments across different geographic regions can provide significant rewards for your portfolio as well
- Europe has lagged the considerable upswing seen on this side of the Atlantic over the last few years but that now appears poised to make up for lost time
- The European economy is showing signs of gaining traction just as the ECB's begins its aggressive asset purchase program
- The European stock market trades at a comparatively cheaper valuation than the American market and offers a better yield
- There is tremendous opportunity to increase exposure to globally diversified, European-based businesses that can benefit from foreign exchange tailwinds and tap into stronger international markets
- Our view is that the outperformance seen so far this year is the beginning of a trend that will play out through 2015 as the European markets make up for lost time

The relatively less attractive fundamentals and clouded outlook saw European financial markets fall out of favour and stocks lagged their North American counterparts — from the March 2009 lows to the end of 2014, the S&P 500 surged 200% versus a gain of 115% for the European STOXX 600.

The relatively less attractive fundamentals and clouded outlook saw European financial markets fall out of favour in recent years

THE TURNING OF THE TIDE

There is no doubt that the U.S. economy is still the smartest kid in summer school. However, at some point that gets priced in. That is what we are seeing with the comparatively expensive valuations for U.S. equities.

And while the earnings outlook in the U.S. remains positive, momentum is slowing as a strong currency crimps foreign-sourced income (S&P 500 companies derive just under half of their revenues from abroad) and the period of monetary policy easing is drawing to a close. Add to the mix the fact that margins sit at record highs and cannot go up forever, and profits are facing a more challenging environment than they have seen in recent years.

In contrast, the European economy is gaining traction just as the ECB begins its aggressive asset purchase program, which has already served to undercut the euro currency.

Earnings momentum in Europe is benefitting from the boost that a cheaper euro provides to international competitiveness — not to mention the positive currency translation on foreign-derived revenues — as well as profit margin expansion from lower interest rates, the positive impacts of cost-cutting and restructuring efforts, and the slide in global energy prices.

FROM HEADWINDS TO TAILWINDS

Now is the time to start shifting focus to the markets that have lagged and offer more compelling relative valuations.

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In the U.S., investors are paying 17.2x S&P 500 forward earnings that are facing headwinds from the strong dollar. The European STOXX 600, conversely, currently trades at a comparatively cheaper valuation of 14.5x forward earnings that have the benefit of a currency blowing a nice tailwind into their sails. Additionally, the STOXX 600 is expected to deliver 7% EPS growth in 2015 versus only 4% for the S&P 500.

As well, given the contrasting experiences seen by their respective economies in recent years, the bar set for expected performance in Europe is notably lower than that faced by the U.S. — providing potential for greater upside surprise across the pond than stateside.

Further, recent history has shown that the periods following the introduction of central bank asset purchase programs (quantitative easing) have been unequivocally positive for equity markets — with returns in excess of 20% seen in the year after the market intervention by central banks in Japan, the U.S. and the U.K.

One reason for this is that investors are left with the choice of depressed yields offered on fixed-income securities or the comparatively higher returns offered up by stocks. The same should hold true in Europe where investors now have to choose between zero or negative interest rates in the money market and bonds with short-to-medium maturities or a 3½% dividend yield on the STOXX 600.

European dividend yields exceed yields available in a large swath of the fixed income market

ROOM TO RUN

So far in 2015, despite all the angst, equity markets overseas have outperformed the North American markets — the S&P 500 has increased by just 1% year-to-date while the STOXX 600 has posted a 10% gain.

Our view is that this is the beginning of a trend that will play out through 2015 as the European markets make up for lost time.

We have seen significant funds that have flown to the U.S. (for good reason) and out of Europe to fairly extreme levels in recent years; however, we have already begun to see some reversal of this trend as money flows back into Europe seeking the lower valuations, higher dividend yield, easy monetary policy, and potentially faster earnings growth and earnings momentum.

There is tremendous opportunity to increase exposure to globally diversified, European-based businesses that can benefit from foreign exchange tailwinds and tap into stronger international markets — including the U.S. economy, which remains the engine that will drive global growth — as well as select secular growth trends.

There is tremendous opportunity to increase exposure to globally diversified, European-based businesses

Our Daimler AG (Germany) position fits the bill. The largest division within the company is Mercedes, which is a very strong brand in the premium automotive space. After underinvesting in their brands and having an incomplete lineup, Mercedes is now benefitting from a strong model cycle. There are also internal programs which are aimed at closing the profit margin gap relative to peers. On top of all this, Mercedes is enjoying strong automotive markets globally. We find valuation still attractive and the stock provides a dividend yield of 3.3%.

There are also benefits to adding European stocks to a portfolio from an income-investing standpoint — not only is the 3½% dividend yield offered by the STOXX 600 higher than most global bond yields, it is materially higher than the 2% yield on the S&P 500.

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We have a position in an infrastructure company called Ferrovial SA from Spain. This company has some tremendous assets including a 43% interest in Canada's 407 ETR and 25% interest in London's Heathrow Airport. Other businesses include toll roads, infrastructure construction and services primarily in North America and Europe. Not only does this company provide high quality assets and some leverage to an improving European economy, they are also returning capital to shareholders through a dividend yield north of 4% and a share buyback.

THE CASE FOR A BROADER GEOGRAPHIC BASE

The U.S. stock market remains strong and the odds are in favour of high single-digit returns this year, but there is greater upside potential elsewhere in markets that have lagged and now have the benefit of a competitive currency, monetary stimulus and a compelling gap between dividend yields and bond yields. For this reason, expanding your portfolio to include a focus on well-managed European companies could prove to be a prudent decision.

Kai Lam

Vice-President & Portfolio Manager

Mr. Lam is a Vice-President & Portfolio Manager focusing on global equities. Mr. Lam received a Bachelor of Commerce degree with First Class Honours from Queen's University. He has also earned his Chartered Financial Analyst (CFA) designation. Prior to joining Gluskin Sheff in 2001, Mr. Lam was Vice-President of Research with Thornmark Asset Management focusing on North American equities. Prior thereto, Mr. Lam was with CIBC World Markets as an Institutional Equity Research Associate.

Gluskin Sheff

Gluskin Sheff at a Glance

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For further information, please contact research@gluskinsheff.com

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