thenavigator

Spring 2016

“Close, but no cigar”

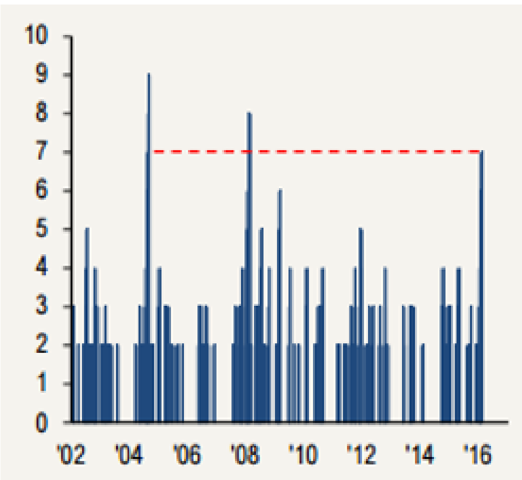
In the last newsletter we talked about the pendulum swinging between fear and greed, and how markets were firmly stuck in the fear part at that point of writing, and that things were likely to get better.

It seems that the market is an avid reader of our publications! Lo and behold, out of nowhere a vicious “rip your face off” rally miraculously appeared and the fears of a global recession dissipated substantially. It was just the usual annual growth scare, which started off with China worries and then spread like a global virus culminating in severely reduced expectations of US interest rate increases and a stock market selling stampede.

European stocks extended their third quarterly drop in four to wrap up what has been the worst start into a year since the financial crisis.

Banks dragged down the Stoxx Europe 600 Index at the end of the month trimming its gain to only 1.1% (we have no exposure to bank stocks within our portfolios).

No. of consecutive weeks of outflows from equity funds

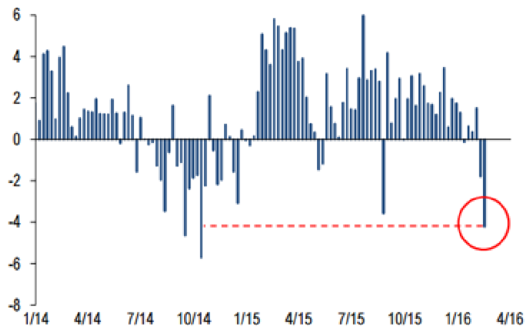


Source: BofAML Global Investment Strategy, EPFR Global

After rebounding 14% in five weeks through March 14, the markets’ advance has stalled, putting its quarterly drop at 7.7%. That is the worst first-quarter performance since 2009, with all but one of 19 industry groups falling.

After beating U.S. equities last year by the most in a decade, European stocks are now trailing them to the tune of 8.8% - the most since 2003. However, European stocks have bounced back from every quarterly drop but one since 2011. Yet, companies in the index appear to be losing their two remaining lifelines: analysts have further slashed profit estimates for this quarter on the back of an economy that continuously misses projections for the year. Furthermore, fund managers have withdrawn money for seven straight weeks, the longest streak since 2014, according to a study from Bank of America Merrill Lynch Global Research and EPFR Global. Looked at on a longer term perspective, the length of outflows from equity funds was only surpassed twice in the past thirteen years. A contrarian investor would surely consider this a bullish signal.

Weekly flows to European funds ($bn)



Source: BofAML Global Research, EPFR Global

Whilst our overall call on global markets' rebounding was correct, the belief that Europe would outperform was premature at least in the very short term, as US markets significantly outperformed during the rebound and were more defensive on the downturn. However, our disciplined investment philosophy ensures that we are well diversified not only geographically but also among various asset classes. As such our gold exposure helped due to its 10.8% price increase over the quarter, while bonds were also supportive as falling yields raised their prices.

Currency markets further contributed to the overall volatility in equity markets. Given the monetary largesse of the European Central Bank, we continue to hedge the euro in USD mandates, preferring a neutral stance with the intention to soften the portfolio volatility.

Unsustainable

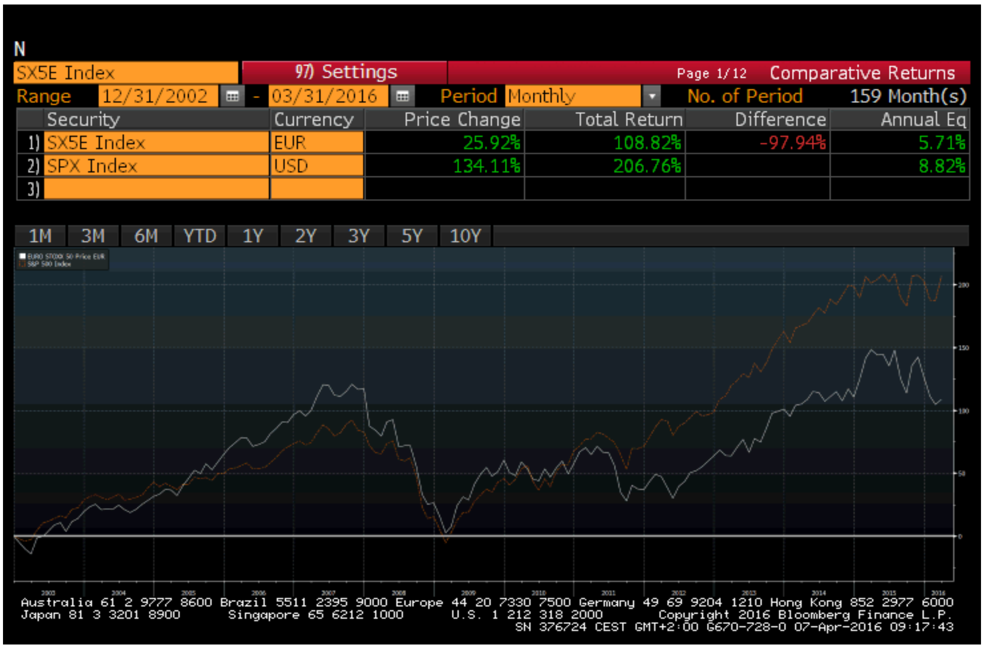
Comparing European and American equity markets over a longer term, the underperformance gap has never been wider and seems to be resting at unsustainable levels of divergence.

We could very well be entering a multi-year time period where European equities close their underperformance versus US indices and possibly start to outperform, as we have seen in the period from 2005-2007.

Looking at the fundamentals for the European markets (Eurostoxx 50), the dividend yield of 4.08% compares favourably with the 10-year German Bund yielding 0.10%. In contrast, the S&P500 yields 2.21% versus 1.71% for the 10-year Treasury. Not only is the absolute dividend yield more attractive, but the difference between the respective dividend and bond yields also speaks in favour of Europe.

Earnings growth for both Europe and the USA are expected to be mildly positive this year, mainly driven by an expected second half recovery. While growth rates for companies in the S&P500 are expected to be somewhat better than for the ones in the Eurostoxx 50, given analysts' hefty downward revision of European earnings, this holds the chance of a potential upside surprise. With this year`s PE (price-earnings ratio) of 17.4x for the S&P500 and of 13.2x for the Eurostoxx 50, the valuation gap may be too wide.

Performance S&P500 vs. Eurostoxx 50



Source: Bloomberg

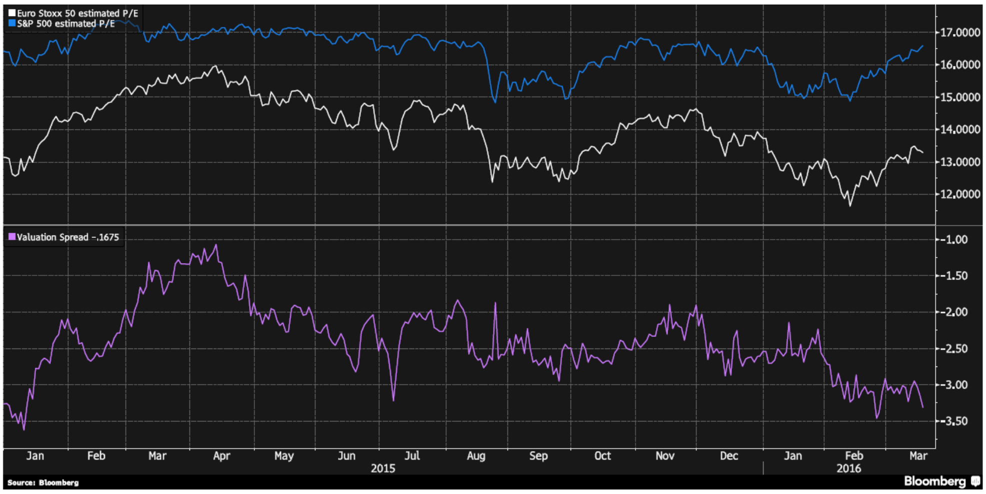
Looking at 2017 expected earnings growth they are broadly similar for both regions.

Yet the S&P500 trades on a PE of 15.2x earnings whilst the Eurostoxx 50 looks rather

attractive on a PE of 11.7x forecast earnings for 2017.

However; time is an important factor and we believe, that we are only at the beginning of what could take years to unfold.

PE ratio and PE spread of S&P500 vs. Eurostoxx 50



Source: Bloomberg

Turning to central bank policies, which have become increasingly important, the new TLTRO 2 policy by the ECB is effectively giving free money to the banks to lend to the real economy.

The new series of four loans allotted between June 2016 and March 2017 have a fixed maturity of four years and carry an interest rate of 0% and going down to minus 0.4% if banks hit their loan targets. Effectively this means that banks are paid 0.4% by the ECB, if they borrow money from the central bank and lend it to consumers and businesses.

There are early signs that money flow within the Eurozone is already improving. Recent data showed that lending to Eurozone non-financial corporations and households has been growing at its fastest pace since late 2011.

This is akin to strapping a supercharger on to a high capacity V12 engine! Of course, we have seen this story many times before and the ending was not pretty.

Heads - I win, tails - you lose!

Looking at some of the many issues facing Europe, Grexit (Greece exits the Eurozone) and Brexit (Britain exits the European Union) are perhaps the two most poignant.

Taking lessons from the past, it seems as if European leaders are capable of making decisions, but this only tends to happen, when they are at the crescendo of a crisis.

Thinking laterally, what could happen if Britain left the European Union (EU)? Well, if we look at the analogy of a Western, I expect the cowboys (the EU) to circle their wagons in a protective formation. Europe could very well be forced to integrate faster than many of its member countries wanted before, and the culmination of the European project would hit warp speed.

If Britain remained in the European Union (our base case), would there be then anything left to worry about? I am also quite confident that the EU would provide sufficient disincentives to avoid similar popular votes elsewhere.

"The boy who cried wolf"

I am sure you are familiar with the story of "the boy who cried wolf" one too many times, so that, when eventually the wolf did come, no one helped him.

Reading some of the headlines listed below you will be surprised to hear that Europe is still in existence!

- 2011: *Time:* "As the Crisis refuses to calm, scenarios of Euro collapse appear"
- 2012: *Foreign affairs:* "The failure of the Euro"
- 2013: *CNN:* "Cyprus endgame: What happens if its Banks collapse?"
- 2014: *PNW:* "Collapse of Italy's bank could plunge the European financial system into chaos"
- 2015: *The World Post:* "The collapse of Europe?"
- 2016: *The Guardian:* "Europe's economic crisis is getting worse not better, says Caritas report"

See what I mean…

It proves for markets, that, if everyone is asking the same question, it is normally the wrong question.

Despite the slight discomfort we feel from being overweight in European equities, we do not believe in an investment philosophy of chasing trends but prefer to base our decisions on fundamental research, lateral thinking, and keeping our minds open. We, above all, relish reading views diametrically opposed to ours.

To paraphrase a famous song by Bob Dylan "The times they are a changing".

The slow one now
Will later be fast
As the present now
Will later be past
The order is rapidly fadin'
And the first one now will later be last
For the times they are a changin'

Writer:

Peter Ahluwalia, Chief Investment Officer

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