Eurozone: Ugly Headlines, Resilient Data

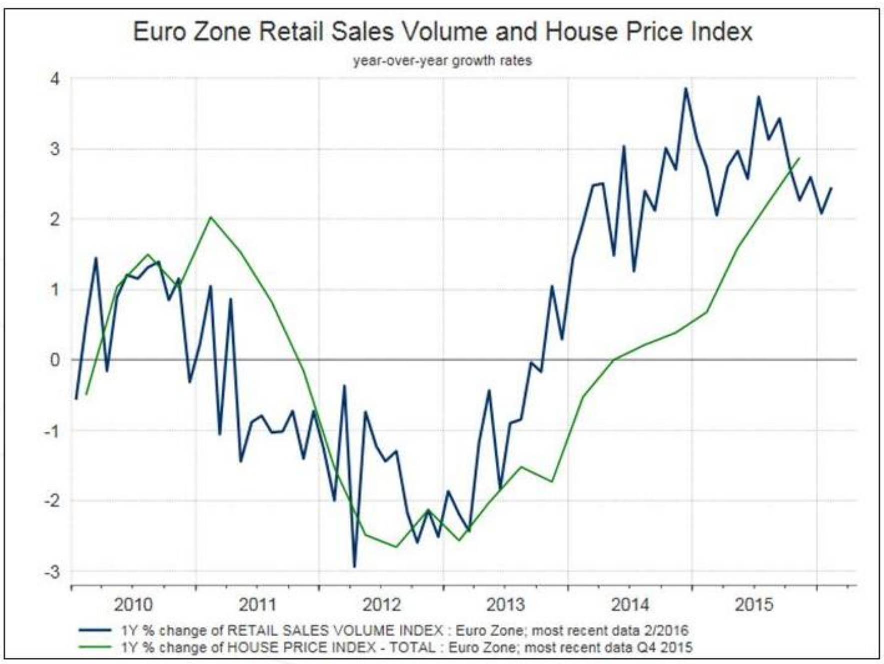
Chris Konstantinos, CFA
DIRECTOR OF INTERNATIONAL PORTFOLIO MANAGEMENT

The Eurozone is not an easy story to believe in. Years after the onset of a credit crisis that continues to test cultural and economic resolve, the region is still the setting for some of the world's ugliest news headlines. Terrorism, questions of solvency in the banking system, and a still-simmering migrant crisis are but a few items that have assaulted markets in recent months.

As value investors, we believe that sustained ugly headlines over time can create attractive entry points for assets. We tend to think that bad news eventually begets cheap prices, which begets outsized future returns. Riverfront's Price Matters® asset allocation process is suggesting that, at current prices, developed international stocks (including the Eurozone) offer attractive potential 5- and 10-year forward returns, if history is any guide. (See our Strategic View, dated 3/2/16, for more on this topic.)

However, many investors are understandably asking us a different question: why do we believe that any of this value is set to be realized over the next 12 months? After all, valuation can be a poor timing tool, and being "early" in the portfolio management business is the same thing as being wrong. The purpose of today's Weekly View is to lay out a transparent framework for some of the recent data that informs our preference for Eurozone stocks, as well as to show how we monitor the risks to our view.

KEY DATAPOINTS THAT WE ARE WATCHING



Source: Thomson Reuters Datastream, RiverFront Investment Group. Past performance is no guarantee of future results. Please see the end of this article for important disclosure information.

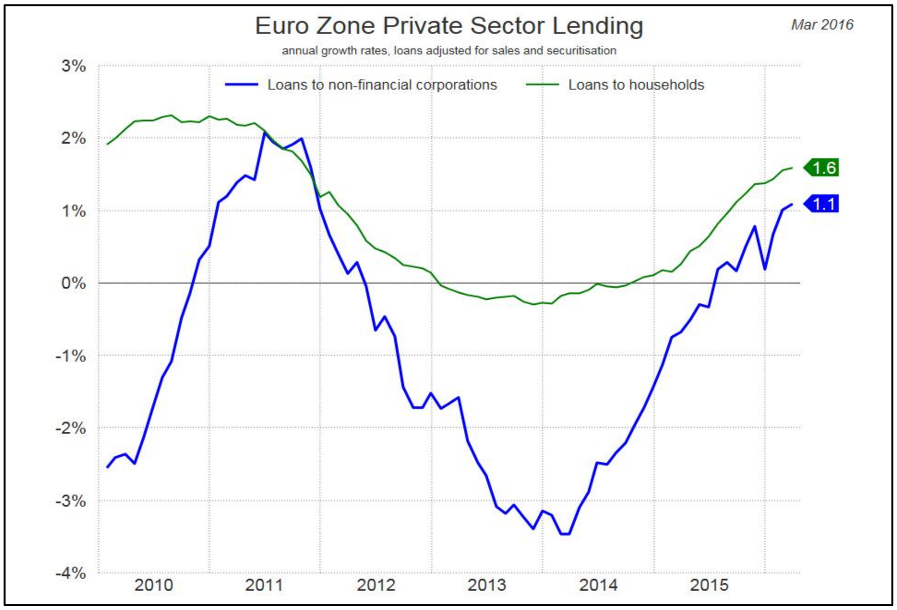
1. **<u>Consumer Data – We believe Eurozone consumer is healthier than it appears.</u>** Despite the problematic news backdrop, data on the Eurozone consumer continues to be relatively solid, in our opinion. Eurozone retail sales volume and house prices have improved meaningfully since the Eurozone emerged from recession in mid-2012. Consumer confidence in a bellwether economy such as Germany (as measured by the GFK consumer climate survey) has also improved over the same time period, and, more recently, beat consensus this past Wednesday.

   What is the cause of the resilient consumer? We believe it is in part due to low energy prices, an improving employment picture, a less austere fiscal stance, and ultra-low interest rates across Europe that keep the price of financing low and the incentive for saving unattractive. This is important, as Riverfront's current overweight to the Eurozone relative to both our strategic and composite benchmarks is primarily within domestically focused, consumer-facing sectors (consumer discretionary, consumer staples, telecom and utilities, and small-caps).

2. **<u>Lending and business confidence improving – early signs that QE is working?</u>** It has become en vogue to question the efficacy of quantitative easing (QE), and in fact of central bankers in general. This is understandable, given the lack of inflation globally and concerns that unprecedented levels of monetary stimulus may lead to unforeseen long-term side effects. The best analogy for QE we can think of is that of a radical medical treatment; one that may save a patient's life but can also cause unintended side-effects long after exit from the ICU.

So, for all the potential long-term side effects, is QE having any near-term positive effect at all? We believe an unbiased examination of the efficacy of the first 16 months of QE in the Eurozone should consider that data relating to lending and business confidence is improving. **This suggests to us that the economy is improving despite a lack of inflation**. Business confidence, as measured by the IFO Eurozone Economic Climate index, measured 118.9 in Q1 of 2016, up from its pre-QE announcement level of 102.3 in Q4 2014, and well above its long-term average of 102.1 from 2000-2015 (*source: IFO Council, Datastream*).

Despite well-publicized concerns about the effect of negative interest rates on the European banking system, we are seeing both the supply and demand for loans improving. Private sector lending to both companies and households continues to recover and grow (see chart below).



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3. **<u>Corporate Earnings – Eurozone exporters and SMID-caps grew earnings faster than the S&P 500 last year, and we believe it can happen again</u>.** US investors looking at Eurozone equity performance could be excused for thinking that the Eurozone had a bad year in 2015. After all, many widely followed US-listed European ETFs had negative returns last year. However, those US dollar-denominated returns obscure the fact that most Eurozone stock markets had positive returns last year in local currency terms, before factoring in the euro currency's (EUR) drop of over -11% relative to the US dollar (USD).

   How did the Eurozone outperform the US last year in local terms, given all the negative news flow? We believe it was in part due to Eurozone corporate earnings in certain sectors that outperformed their US peers, particularly in consumer and/or export-focused industries. We have calculated that a dividend-weighted basket of over one hundred large-cap, high quality Eurozone exporters (which we view as an adequate proxy for the securities that make up a meaningful part of Riverfront's portfolio exposure in the region) experienced average earnings per share (EPS) growth of approximately +10% in calendar year 2015 (*source: Factset Data Systems*). This compares very favorably with an S&P 500 that barely managed to grow earnings at all last year, in our opinion.

   Similarly, European small and mid-caps (SMID) also have had strong earnings profiles relative to US stocks. According to JP Morgan's SMID Research team, 2015 actual EPS growth for Western European SMID companies was +10.4%, with approximately +17% growth expected in calendar year 2016, according to IBES consensus estimates (*source: JP Morgan, April 4, 2016).* Riverfront also has a meaningful tilt towards small and mid-cap Eurozone companies in our portfolios.

   Can earnings momentum continue for quality Eurozone companies in 2016? While we expect lower outright growth in 2016, we are still cautiously optimistic given solid Eurozone economic data, a stable global economic growth outlook, some signs of China's economy stabilizing and dovish stances from many of the world's central banks, including the US Federal Reserve.

KEY RISK FACTORS WE ARE MONITORING

1. **Monitoring bank and sovereign CDS spreads.** One major risk factor in the Eurozone is the health of the banking system, as evidenced by the contingent convertible bond scare in January. One useful real-time financial stress indicator is to monitor credit default swaps (CDS) on major Eurozone financial institutions. CDS are derivatives that act as a type of insurance against

corporate debt default – and, their publicly-traded nature make them a good real-time window into market-perceived credit stress. CDS spreads for Eurozone banks spiked meaningfully in January, indicating heightened risk, but generally not nearly to the same levels seen during the 2011-2012 crisis - despite some of their equity share prices revisiting crisis-era levels. Furthermore, most bank CDS are now back to much more normalized levels, in our opinion.

While the European financials sector is one of our least favorite areas in Europe to invest, we believe the risks to the mega-cap banks are related more to earnings risk, not solvency risk. Eurozone banks have meaningfully increased their Tier 1 capital weightings since 2011, and we believe the post-crisis establishment of the ECB as the pan-Eurozone regulator and buyer/lender of last resort has drastically reduced solvency risk among the SIFI (Systematically Important Financial Institution) banks. We would point to the recent announcement of a “bad bank” funding solution in Italy as an overdue but welcome move supported by regulators to reduce solvency risk.

CDS are also traded on sovereign (government-issued) debt for specific countries and can give a more generalized view of geopolitical and/or economic risk. CDS trends in Eurozone countries are similar to banks, in that peripheral countries such as Spain and Italy saw CDS widen in the beginning of 2016 but improve more recently, and in that 2016 moves were nowhere near as dramatic in magnitude as 2011-2012. We will continue to watch both types of European CDS closely as a warning signal.

2. **Monitoring currency trends.** The EUR/USD currency cross has been stuck in an intermediate-term trading range between approximately $1.05 and $1.15 since the beginning of 2015. We think this range is likely to stay in place for the time being; thus, being close the upper end of that range currently, we are inclined to continue to hedge a meaningful amount of our EUR exposure back to the USD. However, should the EUR breakout definitively to the upside meaningfully above $1.15, we may need to rethink both our preference for hedging the EUR, as well as our preference for the global export-focused Eurozone equities mentioned above.

3. **Monitoring the economic ramifications of political controversy.** The risk of “Brexit” in the UK. Fringe political parties in France. The refugee crisis. Friction among factions within the ECB. Terrorism. What do all these things have in common? They are all economic risk factors directly or indirectly related to political tensions. While politics are unpredictable, we view German politics as being as perhaps the most important in the region, given Germany’s place as economic and cultural thought leader of the Eurozone “experiment”. Regarding the migrant crisis, we recognize that German leader Angela Merkel’s personal and party popularity has suffered due to her stance on this issue. However, we also believe that no credible political challenger to Merkel exists within Germany currently; this means political risk may be lower than it would appear. While we agree that the long-term ramifications of the vast numbers of Syrian and other refugees are still to be determined, it is worth mentioning that immigration potentially holds the cure to one of Western Europe’s largest long-term problems – a rapidly aging demographic. We also think it’s underappreciated that the amount of government spending per immigrant that will need to occur may actually serve to boost Eurozone GDP in 2016.

Important Disclosure Information

Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.

In a rising interest rate environment, the value of fixed-income securities generally declines.

Using a currency hedge or a currency hedged product does not insulate the portfolio against losses.

Dividends are not guaranteed and are subject to change or elimination.

Small-, mid- and micro-cap companies may be hindered as a result of limited resources or less diverse products or services and have therefore historically been more volatile than the stocks of larger, more established companies.

RiverFront’s Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation. Diversification does not ensure a profit or protect against a loss.

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***IFO Eurozone Economic Climate Index** is based on a quarterly survey of numerous countries on business cycle developments and other economic factors in the experts’ home countries.*

***Standard & Poor’s (S&P) 500 Index** measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market. It is not possible to invest directly in an index.*

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