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Europe: Stocks Making Headway Even in a Volatile Market

Since February, concerns over inflation in the U.S., protectionist trade policy, softening economic data, and declining tech valuations have taken the excesses out of global market sentiment, a welcome development in our view. Given our portfolio positioning, one interesting trend occurring underneath the surface is the improving performance of European equities even amidst the volatility. **Not only has the Eurozone’s relative strength improved markedly since early March (see chart below), but local European stocks have posted positive absolute returns in contrast to the negative returns posted by U.S. indices like the Dow Jones Industrial Average, S&P 500, and Nasdaq Composite.**

WHY EUROPEAN STOCKS ARE PROVING RESILIENT, IN OUR OPINION

Europe doesn’t appear to be in the gun-sights of U.S. trade hawks: A

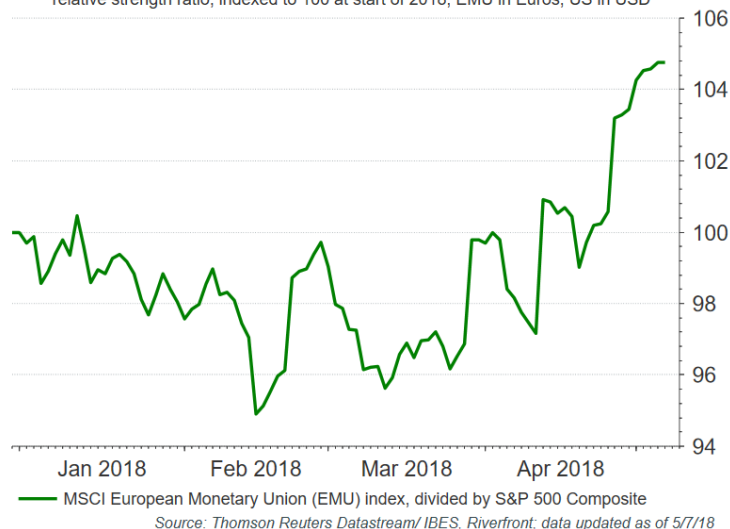
couple months ago, U.S. trade representatives got into a rather public spat over terms of trade with the European Union. Since then, however, the U.S.’s bark has been worse than its bite. For example, just last week the Trump Administration extended the exemption for EU steel and aluminum tariffs for another 30 days. Clearly the administration is more focused on equalizing trade terms with

China, whom it views (rightfully so, in our opinion) as the most egregious trade offender. While trade terms between the EU and the U.S. on certain items (for instance, automobiles) perhaps deserve renegotiation, in general bilateral tariff rates between the EU and the U.S. are similar. We believe this suggests that trade issues with the EU are limited and not as pervasive as they are with China. For this reason we think the market has it right when it did not punish Eurozone stocks during the ‘protectionist panic’ period (after the March 8 tariff announcements).

Rising long-term rates are good for the financial-heavy European indices: One of the major differences between U.S. and European indices is the relative lack of tech exposure in Europe; while technology makes up ~25% of the S&P 500, it’s only roughly a fifth of that weighting in Europe. Instead, financials are the largest sector in Europe, representing over 20% of the equity market.

This has clearly been a relative negative for Europe over the past few years, as U.S. tech has been a superstar and European financials have struggled through their own version of the U.S. banks’ post-credit crisis woes. However, we think the tide might be turning in Europe’s favor.

Eurozone vs. U.S. local stock market performance
relative strength ratio, indexed to 100 at start of 2018; EMU in Euros, US in USD

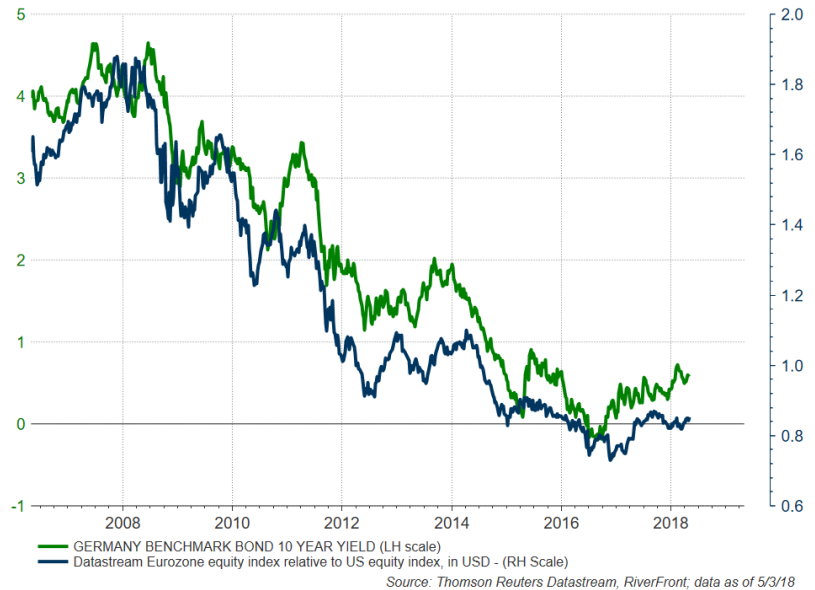


Past performance is no guarantee of future results. Not indicative of RiverFront portfolio performance. You cannot invest directly in an index.

Similar to the dynamic in the U.S., longer-term government bond yields in the Eurozone are starting to rise. As we wrote about in our 2017 *Outlook*, there has historically been a strong positive correlation between the direction of the German bund yield and the strength of Eurozone equities relative to the U.S. (see chart below).

We suspect a major reason is the financials-heavy weighting in the Eurozone index; bank stocks tend to like rising long-term interest rates, as rising rates positively impact a bank's profitability. Bank stocks particularly enjoy rising rates if the reason that rates are rising is because the economy is growing – the situation that Europe now finds itself.

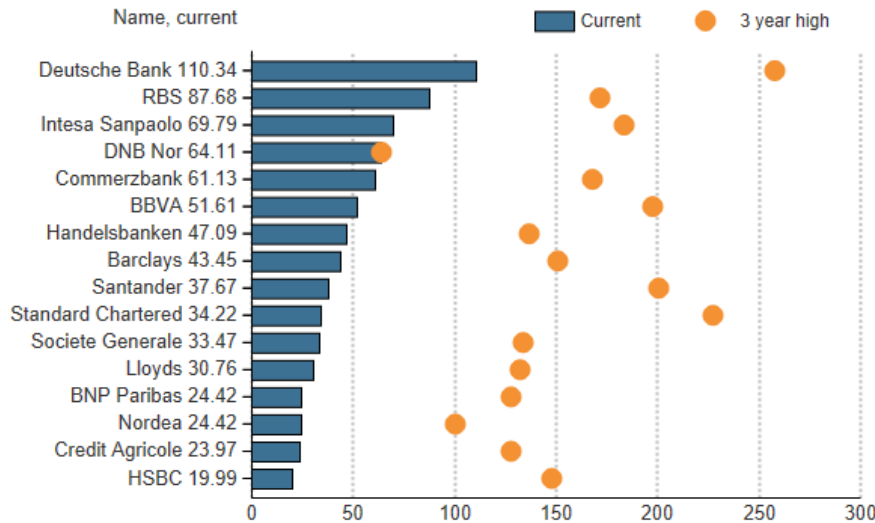
It's also worth noting that European banks, similar to U.S. banks from 2012-2013, are now through the worst of their regulatory scrutiny, in our view. Bank balance sheets have been shored up and capital adequacy has been improved, which has meaningfully reduced the threat of insolvency. This can be seen in the graph below left, which compares current credit default swap (CDS) spreads on Europe's largest banks relative to the highs over the last three years. Credit default swaps are securities an investor can purchase to protect themselves against a default. Additionally, many European banks are starting to reinstate and even in some instances grow dividends. Given that many macroeconomic aspects of Europe are roughly 3-4 years behind the U.S. in our opinion, the next few years may be a surprisingly good time for European bank equities – just as 2012-2015 was for the U.S. banks, 4 years after the end of the U.S. credit crisis.



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European banks' CDS prices

5 year senior CDS price - basis points



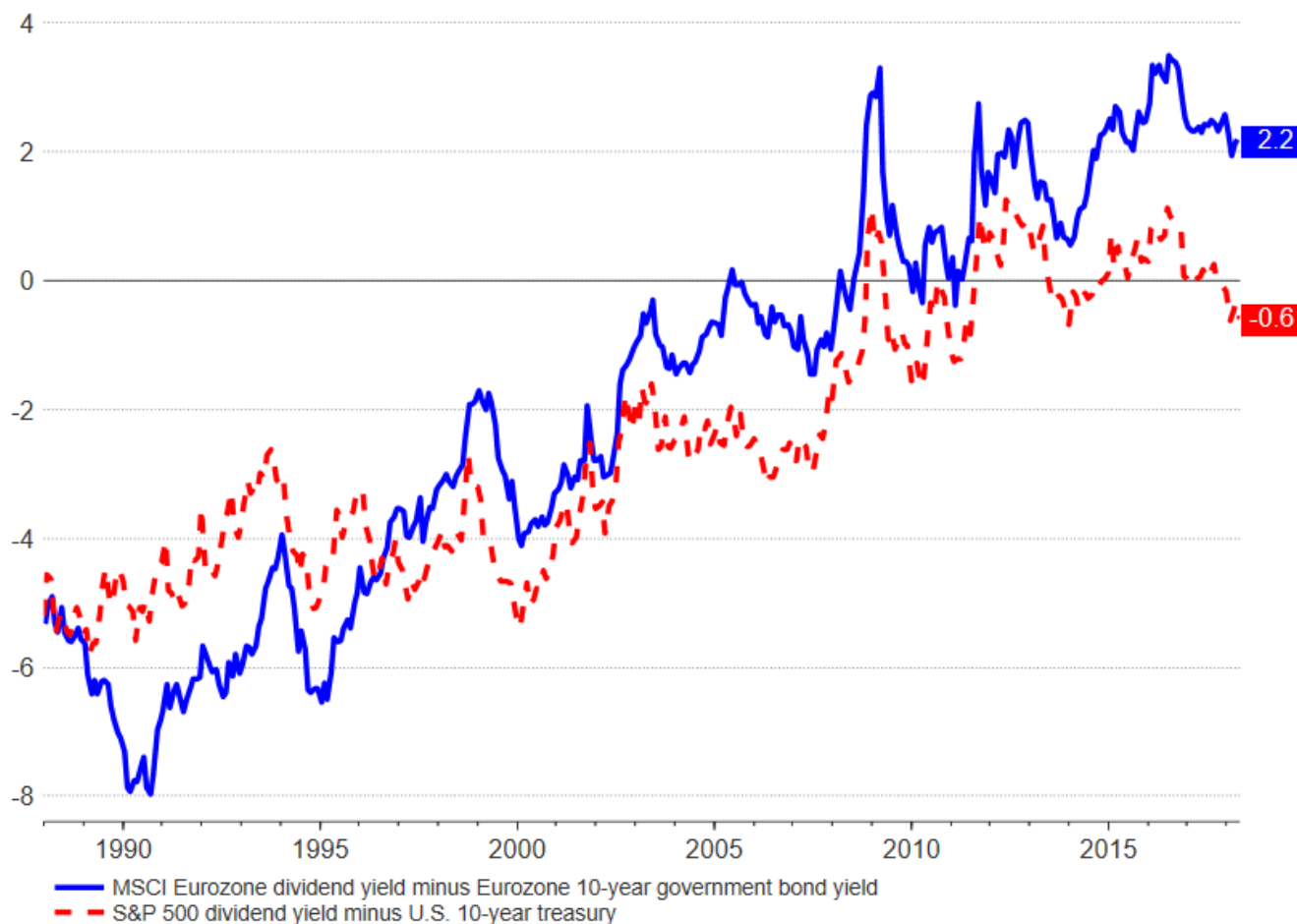
Source: Thomson Reuters Datastream; Data as of 5/7/18

ECB still accommodative; positive for equities: the European Central Bank (ECB) meeting in late April and last week's core inflation data out of the Eurozone both suggest to us that the ECB has no choice right now but to continue running an extraordinarily accommodative monetary policy. Core inflation in April in the Eurozone surprised to the downside, from 1.0% in March to 0.7% in April, its lowest level in over a year. While seasonal effects likely had something to do with the miss, we still think it helps underline that core inflation trends in the Eurozone are well below the ECB's target of 2%. We think there are many reasons for the low levels of inflation. One of the most important is the fact that there is meaningful spare

capacity in the region's economy which is keeping wage growth subdued. We suspect that, while the ECB may formally end QE at some point in 2018, it will be multiple years before they will raise short-term interest rates. We think this bodes well for risk assets in Europe.

Equity yields still attractive relative to bond yields in Europe: There are many different ways to gauge relative valuation of international to U.S. stocks; one simple way is to compare equity dividend yields of a particular region to that region's risk-free bond yield. In our Chart of the Week below, we show Eurozone dividend yields minus 10-year government bond yields. Thus stockholders are now receiving higher cash flow than bondholders, which is historically unusual. We think this will result in a rotation by investors out of European bonds into yield-bearing equities. In contrast, U.S. equities offer 60 basis points less yield than the U.S. 10-year treasury.

CHART OF THE WEEK: DIVIDENDS IN EUROPE WELL ABOVE BOND YIELDS



Charts shown for illustrative purposes only. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

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

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.

Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.

Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries. Using a currency hedge or a currency hedged product does not insulate the portfolio against losses.

Relative strength is a momentum investing technique that compares the performance of a stock, exchange-traded fund or mutual fund to that of the overall market. Relative strength is a “buy high, sell higher” strategy that assumes a stock whose price has been rising will continue its upward trajectory.

Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

Index Definitions:

The MSCI EMU Index (European Economic and Monetary Union) captures large and mid cap representation across the 10 Developed Markets countries in the EMU*. With 248 constituents, the index covers approximately 85% of the free float-adjusted market capitalization of the EMU.

Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Dow Jones Industrial Average Index -- measures the stock performance of thirty leading blue-chip U.S. companies.

The Nasdaq Composite Index is the market capitalization-weighted index of approximately 3,000 common equities listed on the Nasdaq stock exchange.

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