



Headwinds Shifting to Tailwinds in International Markets

Key Takeaways

- ▶ After a decade of being out of favor, international value stocks are overdue for a comeback.
- ▶ Europe's high exposure to cyclical stocks is evolving from a drag to a benefit as prices firm and the yield curve begins to steepen.
- ▶ Accelerating earnings growth and stimulus measures are expected to drive international stock performance going forward.

International and value equities have been playing catch up to their U.S. and growth counterparts since the global financial crisis. Failure of foreign central banks to move as quickly and decisively as U.S. policymakers in stemming credit losses are partially to blame for lagging stock performance. The composition of value indices, with their close ties to sectors hurt the most in the commodities downturn and lack of exposure to the best performing sectors during the low growth recovery (consumer staples and information technology), has also contributed to a disconnect in returns.

The MSCI All Country World Ex-U.S. Value Index has outperformed its growth counterpart over the last 12 months – following a decade of underperformance – and we believe improving global growth should continue to support a value comeback. Global manufacturing activity is running at levels well above mean, global trade is recovering and many geopolitical risks have abated. Overall, the deflation trade appears to be sustainable as economic activity increases and corporate earnings improve. Such trends should be particularly favorable to the cyclical sectors that currently dominate value benchmarks, including financials and energy (Exhibit 1).

As value managers, we seek to invest when the discrepancies between stock prices and intrinsic values are at their widest. In some cases, we will be early in taking positions in mispriced companies before valuation gaps begin to close – the slow recovery of European banks and Europe overall are two such examples. Zero inflation and negative interest rates have stifled banks and are one of three headwinds, along with falling commodity prices and weak emerging markets (EM), which have limited GDP and profit growth in Europe. These headwinds have begun to recede, however, creating opportunities for stock price appreciation.

Europe is highly exposed to energy- and commodity-producing companies, two areas where profitability has fallen the most. Commodity declines beginning in 2014 forced

Exhibit 1: International Value Benchmark Tilted Heavily to Cyclical

Sectors	ACWI Ex-U.S. Value	ACWI Ex-U.S. Growth
Consumer Discretionary	9.68%	13.23%
Consumer Staples	1.64%	18.77%
Energy	9.75%	3.13%
Financials	37.89%	7.52%
Health Care	3.51%	12.99%
Industrials	10.55%	13.37%
Information Technology	5.00%	15.70%
Materials	7.26%	8.05%
Real Estate	4.34%	2.15%
Telecommunication Services	5.85%	3.28%
Utilities	4.52%	1.81%

As of May 31, 2017. Source: MSCI.

companies in these sectors to scale back production and investment, leaving unutilized capacity significantly lower. Over the last year, prices of crude oil and industrial metals like copper, iron ore and steel have gradually recovered. As prices and capacity utilization improve, the profitability of energy, mining and related commodity producers should also improve.

The region is also heavily exposed to financials. In addition to nonexistent inflation and negative real rates, European banks have been held back by an onerous regulatory environment that forced many to abandon profitable business lines and reduce leverage to meet new capital requirements. Restrictions are starting to loosen. Meanwhile, improving loan demand is spurring better economic growth, and we are likely in the late stages of monetary easing, which should lead sovereign yield curves in the eurozone to steepen, improving interest margins.

Leading European multinationals including Nestle, Unilever, Bayer, Sanofi and BASF rely heavily on emerging markets, a demand region that has struggled for most of the last five years. But as we discussed in a recent blog, EM consumption has stabilized and is beginning to pick up again. A healthy EM consumer removes the final drag on a meaningful expansion in Europe. Standard Chartered and Banco Santander, with significant operations in Asia and South America respectively, are also well positioned to participate in an EM recovery and an improving backdrop for financials.

More broadly, the eurozone economy is trending in the right direction. GDP in the eurozone grew at an annual rate of 2.0% in the first quarter and is projected to grow at a rate of 1.7% for the full year. Wages are picking up and companies are showing signs of pricing power, which is flowing through to improved margins and profitability. Capital markets activity is also encouraging, with bond issuance picking up as companies re-lever. European companies are returning to shareholder-friendly activities, including share buybacks and M&A. We are also seeing increased corporate spending on talent and infrastructure.

European equities are now on the right side of momentum. Three of the major headwinds holding back earnings have dissipated, if not disappeared. Meanwhile, the fourth quarter of 2016 marked the end of six years of European corporate profit declines, and we're seeing earnings estimates revised upward across the region. In fact, earnings are expected to grow at double-digit rate in every region outside the U.S. this year, according to UBS European Equity Strategy and Thomson Datastream (Exhibit 2). Stocks could also see additional catalysts from fiscal stimulus as austerity measures over the last several years have left many European countries with the budgetary capacity to spend while sturdy balance sheets give companies in Asia leeway to increase capex. For U.S.-based investors, currency conditions also appear favorable as we have likely seen the peak of monetary policy divergence that has caused the euro to fall to a 14-year low against the U.S. dollar.

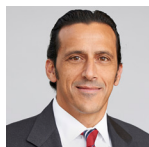
We believe the underperformance of value equities over the past ten years is reversing and that headwinds will abate and tailwinds will begin to stir. Reflation is firmly in place and we have identified significant opportunities in Europe at attractive valuations. Challenges are abating related to politics, nationalism, protectionism – providing the economic growth and rising profits necessary for value stocks to recover.

Exhibit 2: Valuation and Earnings Growth Comparisons Across Regions

Region	P/E Trailing 12 Months	P/E Forward 12 Months	EPS Growth (2017 Est.)	EPS Growth (2018 Est.)
ACWI	18.1	16.1	14%	11%
U.S.	20.1	18.0	10%	12%
EAFE	17.0	15.2	15%	9%
Europe	17.6	15.7	15%	10%
Japan	16.0	14.0	15%	8%
EM	14.1	12.1	20%	11%

As of May 31, 2017. Source: UBS European Equity Strategy, Thomson Datastream.

About the Author



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