Traveling Abroad for Investment Opportunities – Europe Beckons

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The post-election Trump bump has elevated the U.S. market to a lofty PE premium, as the S&P 500 now possesses its highest forward price-to-earnings ratio since 2004. While this can be justified by the ultra-low bond yields and pro-growth Trump policies, this may give some cause to pause before throwing more money onto the proverbial bull market fire. In the search for value, investors have started to take a hard look at overseas economies. Emerging markets, long due for a rebound, have already rallied in-kind with the U.S. market. However, one overlooked market to consider is Europe.

The Current Situation

European shares continue to lag behind in the global market rally. Investors are still smarting from the European debt crisis that began in 2009 and the surprise Brexit vote of last summer. Further tempering the situation is talk of other countries exiting the European Union, leaving the future of the euro in doubt. Looming elections in Germany and France have further muddied the future of the common currency, as populist candidates are holding steady in the polls. Politically, Europe looks like a bit of a shaky bet. European economies have not historically been strong growth candidates, restrained by the aging populations, rigid labor laws and currency constraints.

However, buried beneath the negative headlines surrounding Europe are solidly improving growth trends and economic indicators. Eurozone GDP rose an estimated 1.7% in 2016, driven primarily by falling unemployment rates, rising wages, and strong household spending. The Eurozone unemployment rate has hit a seven-year low, manufacturing growth is at its strongest level since April 2011, and business confidence levels remain high. Last year, the Eurozone economy kept pace with the U.S. for the first time since 2008. European companies outperformed expectations during the most recent earnings cycle. Consensus forecasts are for European corporate earnings to grow at double-digit rates in 2017. In addition, European companies have been significant beneficiaries of the weakened euro. Rising U.S. interest rates will only help this situation. So what's not to like about the future?

Valuations Look Reasonable

The valuation perspective is also positive for European stocks, as the indices look relatively cheap when compared to U.S. levels. The Euro Stoxx 50, the equivalent of the Eurozone's blue-chip index, is up 2.7% in dollar terms year to date versus the 6% gains for both the Dow Jones and MSCI Index. Even the though the Euro Stoxx 50 hit a new high recently, it is still 38% below its peak while U.S. indices continue to hit new absolute records. On a price-to-book basis, European stocks are trading near 40-year lows as compared to U.S. stocks. The likelihood of a continuing strong U.S. dollar vs. the euro, supported by the Fed's recent rate increase, will preserve the

competitive advantage for Eurozone companies. However, note that European stocks have rallied almost 10% since Trump's election, as the euphoria over expansionary U.S. economic policies, coupled with strong economic date in Europe, fueled optimism.

Investors still appear to be favoring the U.S. markets, suggesting they prefer to stick to the more familiar landscape during political and electoral uncertainty. Cumulative fund flows data gathered since Trump's November victory indicate approximately 8.4% entering the U.S. equity market, while flows to European equities totaled 2.7% during the same period. The pending election uncertainty in Europe is likely a factor for this discrepancy.

The Election Wildcard

Investors are still smarting from last summer's surprise Brexit vote, and several upcoming European elections have thrown high levels of uncertainty into the mix. In France, right-wing candidate Marine Le Pen is a self-described nationalist who supports a French exit from the Eurozone. Recent polls show her favored by 25% of voters, which has rattled European markets. In Italy, the anti-Eurozone candidate is also polling strongly. However, in the highly anticipated March vote in the Netherlands, the loss suffered by the populist candidate suggests that pro-populist sentiment may be peaking in Europe. This bodes favorably for the upcoming French and German elections, and has given investors reason to be somewhat optimistic. Political populism continues to rise on both sides of the Atlantic. In the U.S., the Presidential election also wrecked havoc on markets, although the positive rally following Trump's victory left many who bet the wrong way tending to their wounds. The upshot is elections, and post-election market behavior, are very difficult to predict.

European "disintegration" is a major destabilizing force for the market right now. Should another country join Britain and drop out of the euro, all bets are off on who will remain committed to the currency and economic structure. However, it is less clear if there will be long-term effects. Look back to France's Socialist Party president in 2012 and Greece's radical left party elected in 2015. Instead of acting on their campaign pledges to defend pensions and other government benefits, both governments made the tough choices to strengthen their nations' economic positions by enacting tax cuts, labor reforms and budget austerity. The bottom line is while looming elections are injecting some short-term uncertainty into the market, longer term things look positive on a fundamental basis, perhaps making who wins the vote less relevant than investors currently believe. Valuations remain attractive at discounted levels, and many European companies do much of their business outside of the Eurozone, further mitigating risk.

How to Play It

Although there is no way to completely counter the political risk, investors with a long time horizon can benefit by investing in companies that dominate their market and have a record of profitability and growth. Stocks with exposure to U.S. domestic markets are especially compelling, as are those defensive plays that can do well in a slower-growth economy.

British Petroleum (BP): One of the largest international oil and gas firms, BP has emerged in a strong position following the plunge in oil prices two years ago. While Gulf of Mexico liabilities and other legal issues remain, the new administration in Washington D.C provides a more hospitable environment for settlements. The stock is one of the cheapest of the major oil companies, trading at 11X price to earnings, 1.2x book value and yielding a 7% dividend.

Glaxo SmithKine PLC ADR (GSK): One of the largest pharmaceutical companies in the world, GSK has a thriving product pipeline in several therapeutic areas and solid market positions in vaccines and consumer products. Dividend growth has been solid, averaging 6.5% annually over the past decade. GSK currently sports a 4.8% dividend and 16X PE.

Nestle (NSRGY): Swiss based Nestle is the world's producer of food and beverages. Its brand portfolio includes Nestle, Purina, Perrier and a 23% share of L'Oreal. Long considered a core holding given its market leading positions, recent organic growth rates of 3% are far below the recent historical average. Rapidly growing market penetration of emerging economies offers above average growth opportunities, countering lower organic growth rates to some degree. The dividend is healthy at 3%, resulting from a double digit payout increase over the last decade.

European equities should be a core holding in a balanced portfolio, with the region offering geographic, political and economic diversification. Political risk currently remains greater than in the U.S., with several pending national elections injecting some uncertainty into the mix. However, fundamentals remain strong as the global economy rebounds, valuations remain favorable and economic indicators for Europe improve.