Weekly Market Flash

A Contrarian Case for Europe?

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Contrarian investors come in all shapes and sizes, but they all share a variation of this basic way of looking at the world: when the crowd looks one way, it pays to look the other. Today there is an undisputed crowd looking one way -- the Trump reflation-infrastructure trade that shows scant signs of fading, despite a bit of a pause in US equity share gains this week. And there are plenty of good reasons -- we believe -- for looking in other directions, the arguments for which we have set out on these pages in weeks past. But where? This week we consider the merits of one of the least popular asset classes in recent times: European equities.

Europe: The Macro Case

On the face of it, there would seem to be not much to recommend Europe from a top-down analysis of the variables at play. Last year's Brexit vote hangs over the Continent; while the general consensus remains that Britain's exit will hurt its own economy more than that of Europe's, the devil will be in the details of how the parties agree to implement Article 50. Plus, of course, the upcoming elections in France and Germany, and the still-potential wild card of early elections in Italy - will shine a light on the fissures created by anti-establishment sentiment. All this while rattled national leaders and EC technocrats listen for the next approaching Scud missile in the form of a late-night tweet from the other side of the Atlantic.

Valid points, all. On the other hand, the economic health of the region is arguably stronger than it has been since the recession began nearly ten years ago. One of the first macro headlines of note this year was a 1.7 percent reading for consumer price inflation in Germany. Additionally, Eurozone producer prices climbed 1.6 percent year-on-year through the end of December last year. A meaningful part of the jump comes from energy prices; nonetheless, building inflationary pressures would seem to indicate that Europe has moved well and truly back from the deflation trap that seemed all but certain to engulf the region just two years ago. Two cheers, perhaps, for Mario Draghi and his knack for jawboning equity and debt markets.

Moreover, while the upcoming elections could indeed put added stress on the integrity of the common currency region, there is a plausible argument to make against that outcome. Consider the French election, where a victory by far-right populist Marine Le Pen would send shock waves to Brussels. Recently the world learned that the til-now front runner in that race, conservative Francois Fillon, is embroiled in a financial scandal involving fake parliamentary jobs for his wife and children. Apparently nepotism is still a cause for scandal over there - who knew?

The knee-jerk reaction to that news would plausibly be fear that Le Pen, running second in the polls, would vaunt to front-runner status. But wait! The Fillon scandal appears to have worked first and foremost to the benefit of Emmanuel Macron, an independent candidate with a moderate center-left platform who has surged to front-runner status. A Macron win would shake up France's ossified political system, but arguably in a productive way less likely to be a direct threat to Eurozone integrity. Add to that the likelihood of Angela Merkel winning her fourth term later in the year, and suddenly the Great European Crack-up of 2017 looks less probable.

Europe: the Micro Case

What about the bottom-up view? Well, the obvious place to start would be the valuation gap between US shares and their European counterparts. According to Thomson Reuters Datastream, the twelve month forward P/E multiple for the Euro Stoxx 600, a regional benchmark, is less than 15 times. The forward P/E for the S&P 500, on the other hand, is over 17 times. Now, there have been reasons a-plenty to attach higher valuations to US companies in recent years. Nonetheless, when whole asset classes go out of favor there are usually some very good names that get unfairly tarnished with the macro discount brush.

One area where some contrarians may have been seen fishing about recently is for shares of companies with a significant portion of their revenues derived from outside Europe, particularly in North America or China & Southeast Asia. Remember that for every Procter & Gamble there is a Unilever, for every Exxon Mobil a Royal Dutch Shell. And some of the world's leading industrial materials concerns -- a sector particularly embraced by the Trump trade crowd -- hail from Europe, among them Germany's Heidelberg Cement and France's Lafarge. If you really have to play the infrastructure trade, why not play it with more attractively-valued shares?

The Currency Factor

For a dollar-denominated investor, Europe has been a disappointment for many, many years, and one of the main reasons for that has been the secular bull run of the US dollar. The consensus outlook for the dollar remains strong, mostly due to the imagined outcome of a sequence of interest rate hikes in the US while the Eurozone continues to feed its monetary stimulus program. Every percentage gain by the dollar against the euro is a percentage taken away from the price performance of EU shares in local currency terms. For most of the past eight years, that has been a daunting obstacle.

Again, though, if those EU inflation headlines continue into a trend it is likely to, at the least, put upward pressure on intermediate and long benchmark yields in the Eurozone, which in turn would provide some support to the euro. Back in the US, we continue to see the pace of rate increases by the Fed proceeding gradually and below-trend for some time to come (this squares with our view that the tidal wave of net new infrastructure spending is more a creation of hyperactive investor imaginations than actual likely policy in 2017). With the dollar hovering just a few points above euro parity, there is at least a reasonable case to make that the dollar's bull run may settle back a bit from its recent pace -- indeed, we saw perhaps a preliminary sign of this with the greenback's weak January trend.

None of this means that European equities are a fat-pitch obvious source of value. But in a world of expensively priced assets, sometimes it pays to get into the heads of the contrarians and see what they are thinking. We will continue to send reports from this corner of the market as we assess alternative opportunities over the coming weeks and months.

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