The Boston Company

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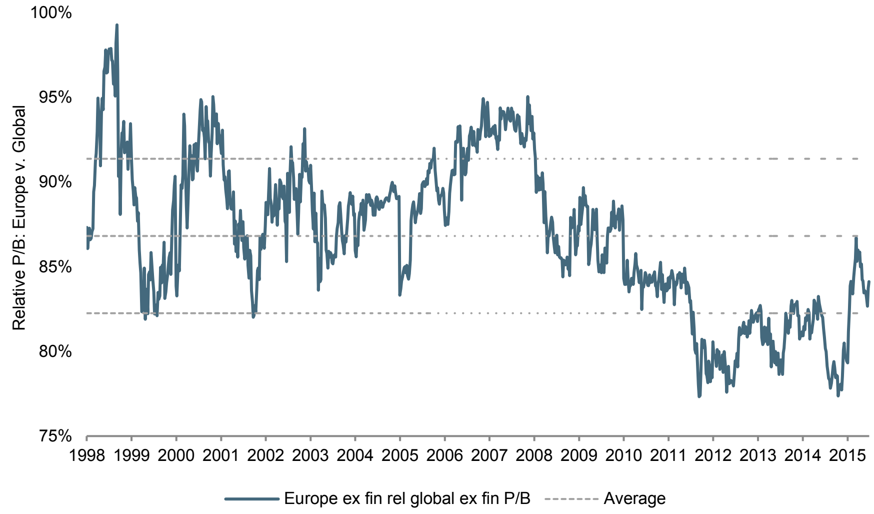
The Sweet (and Sour) Spots in Europe's Equity Market

The storm clouds that once overshadowed Europe's economy have finally begun to clear, and investors are taking notice. Despite the summer's wild volatility, almost $100 billion has flowed into funds exposed to developed European stock markets so far this year.[1]

With so much money coming into Europe, it may be difficult to separate the stocks with more room to run from those whose potential is already priced in. Yet despite the inflows, we still believe valuations are at very attractive levels.

Exhibit 1: Continental European Equities (ex-financials) Recovering from Depressed Levels v. Global Equities



Source: Thomson Reuters, Credit Suisse Research, as of June 2015.

We've been closely tracking trends in the European market for a long time, and are identifying some compelling areas of opportunity in the small-cap space right now. We believe valuations are at some very attractive levels, and we maintain a favorable outlook on the European economy overall. However, as active stock-pickers, we don't believe the proverbial tide will lift all boats.

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Managing Director,
Lead Portfolio Manager

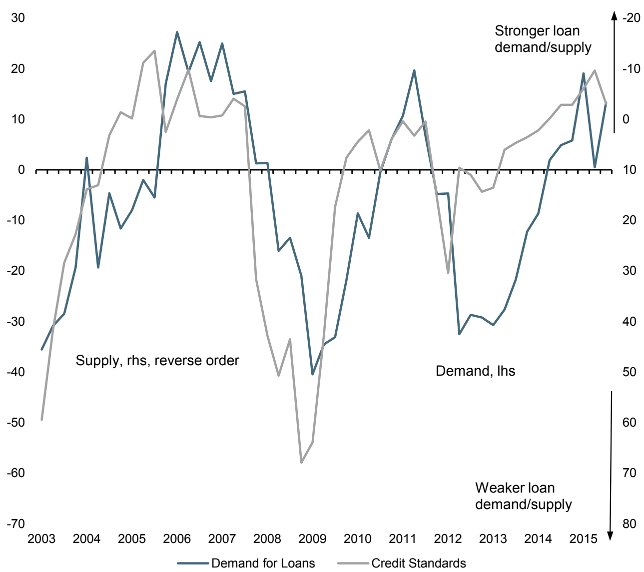
Instead, we employ a fundamentally driven, bottom-up stock-selection process, with a unique "barbell" approach to stock selection and portfolio management. We strive to capitalize on the best value opportunities paired with the best quality growth/momentum opportunities throughout the market cycle.

To do this, a significant part of our work focuses on distinguishing themes and trends that will create either headwinds or tailwinds for specific sectors and/or regions. As such, we are monitoring three promising trends now, and actively avoiding another segment of the equity market.

Positive Trend 1: Europe's economic recovery should buoy the media segment.

Bolstered by the advent of the European Central Bank's quantitative-easing program, the region's domestic economy is undoubtedly on the upswing. Evidence of this can be found in the Markit Eurozone Manufacturing Purchasing Managers Index, which has held steadily above the 50 level (which indicates expansion) since late 2014.[2] Auto sales have also been climbing, with a 12% jump recorded just last month.[3] Loan growth is also recovering.

Exhibit 2: ECB Bank Lending Survey: Demand and Supply for Corporate Loans



Source: ECB, Credit Suisse European Economics Team, as of July 2015. Change over past 3 months.

Amid all these corroborating data points for an improving economy, we anticipate one standout area of opportunity will be the media segment. Specifically, we are closely watching ad-driven companies, such as those that provide outdoor and television advertising. This is because as the economy improves, consumers spend more, prompting companies to then spend more on advertising to reach their targeted buyers.

As part of our "barbell" discipline, which seeks to pair value opportunities with quality growth/momentum opportunities, we are concentrating on media firms in Germany and Spain, as Germany remains the economic powerhouse of the eurozone, while Spain has recently begun picking up momentum.

Positive Trend 2: Italy's Popolari banks are poised for consolidation.

Although Spain's economy is just gaining steam, its banking reforms got under way about two years ago. Around the time of the 2008 global financial crisis, the country's Cajas, or regional savings banks, had been owned largely by the government or trade unions. However, the Spanish government, in an attempt to regain investor confidence in the banking sector, launched restructuring plans that led to consolidation among the Cajas. In the years since, the number of Cajas has shrunk dramatically, but Spain's economic health has also improved markedly in tandem, emerging relatively quickly from the recession.

We expect a similar scenario to play out in Italy, where the Popolari, or cooperative banks, are a key target for reform. These cooperative banks are largely inefficient, and the weaker players are being paired with stronger counterparts in order to clean up their balance sheets as well as the broader banking system. Nonperforming loans at Italian banks swelled more than 14% in July from the year-earlier period[4], and often these take longer than most developed markets to be worked out of the system, given the slow pace of the courts and the lack of fiscal incentives.

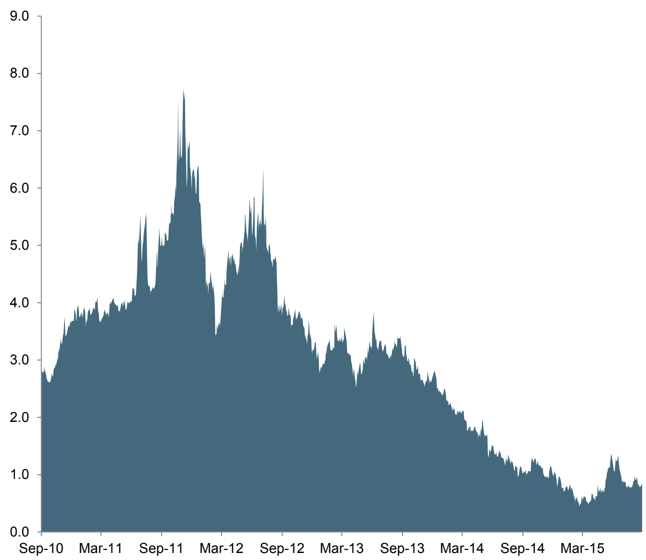
This makes Italian banks ripe for reform, and the Italian government is moving ahead with regulations designed to ease the burden of writing off or selling bad debt. This could ultimately result in an influx of foreign capital willing to pay more to take these loans off the banks' balance sheets. If Spain is any indication, such reform could spur banks' willingness to lend, which is needed if Italy's recovery is to be sustained.

It would also pave the way for more consolidation in the Italian banking industry. Combined with inexpensive price-to-book ratios for the shares, this could pave the way for a rally in select Popolari stocks.

Positive Trend 3: Funds are flowing into Italy's asset-management industry.

Seismic shifts have been happening in the way Italians invest. For many years, government debt has been the country's most popular investment vehicle, providing yields of 5% to 7% just five years ago. Now, however, the 10-year government bond yield is at roughly 1.9% — and investors realize that higher returns are nearly impossible to achieve anymore with government debt.

Exhibit 3: Italy Government Bonds: 5 Year Gross Yield



Source: Bloomberg, as of September 2015.

In addition, real estate has undergone a notable change. Many Italians owned multiple properties, as there was no carrying cost to do so, given the lack of property taxes. That all changed in 2012, when the Monti administration introduced the Imposta Municipale Unica, or IMU, a widely despised property tax that has undergone several attempts at reform and even repeal. Many Italians do not want to pay this tax and as such are selling their real estate. As the extra cash comes into their pockets, they're not finding much appeal in government bonds, as outlined above.

Because of these two factors, asset managers are well positioned to benefit. Investors, possibly flush with cash from property sales and unimpressed with bond yields, have been moving more money into equities as the country's burgeoning recovery continues. Italy's FTSE MIB Index has gained 16% so far in 2015, and we expect asset managers to benefit from investors' ebullience.

Negative Trend: Beware companies with exposure to China's auto industry.

China's economic slowdown is no secret at this point, but we are keeping a close eye on the country's auto industry, in particular. Auto sales in the country have fallen for three straight months, and expectations for growth are being slashed. In fact, AlixPartners LLP said it expects "low single-digit-percentage growth to be the 'new normal' for China's car market, adding that total annual sales volume this year may show its first contraction since 2008."[5]

Companies with exposure to China's auto market are beginning to miss expectations, amid a supply-demand imbalance. Demand has declined among consumers, and new supplies are just coming on. Original equipment manufacturers and suppliers made historically high margins in China, but that trend looks like it has peaked. We are reducing exposure to all firms exposed to the Chinese auto market.

A Wealth of Opportunity

As Europe's economy gets back on track, we are very constructive on the equity market there. We expect leading indicators to continue on a positive trajectory and the central bank to remain accommodative. In the recent past, the recovery has been somewhat restrained by problems in Greece, which have been largely resolved, as well as by China, which the market has already recognized as a potentially longer-term phase. Once we move past those concerns, economic strength should drive earnings growth, and we see a number of attractive valuations worth considering.

End Notes

[1] Gavin Jackson and Elaine Moore, "ECB outweighs Fed as fund flow influence," Financial Times, Sept. 15, 2015. http://www.ft.com/cms/s/0/f4de40d6-5bbe-11e5-9846-de406ccb37f2.html#axzz3m0t132j0

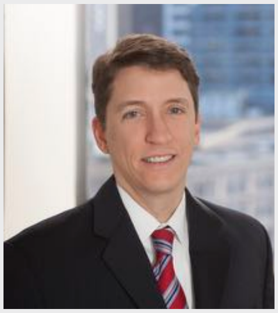
[2] Euro Area Manufacturing PMI, Trading Economics. http://www.tradingeconomics.com/euro-area/manufacturing-pmi

[3] Tom Lavell, "Europe Car Sales Rise as Economy Helps Renault SUV Demand," Bloomberg, Sept. 15, 2015. http://www.bloomberg.com/news/articles/2015-09-15/european-august-car-sales-rise-as-economy-helps-renault-bmw

[4] Danilo Masoni, "Italian banks' nonperforming loans rise to 197 bln euros in July," Reuters, Sept. 8, 2015. http://www.reuters.com/article/2015/09/08/italy-banks-loans-idUSI6N10H02220150908

[5] Rose Yu and Lillian Yin, "China Car Sales Driven Lower by Slowing Economy," The Wall Street Journal, Sept. 10, 2015. http://www.wsj.com/articles/china-car-sales-driven-lower-by-slowing-economy-1441869976

About the Author



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Mark is the head of The Boston Company's Global Equity team and the lead portfolio manager of the International Equity and International Small Cap Equity strategies.

Before joining The Boston Company, Mark served as a portfolio manager at Putnam Investments, overseeing the firm's Consumer Sector group. Prior to that at Putnam, Mark was a portfolio manager for the Global Core Equities strategy, focusing on the consumer and technology sectors. In his 13-year career at Putnam, he also held positions as an equity analyst, working with all styles of stocks (value, core and growth) both domestically and internationally, and as manager of Pricing Operations. He began his career at State Street in mutual fund accounting.

Mark received a B.S. in finance from Pennsylvania State University and a Master's of Management degree from the J.L. Kellogg Graduate School of Management at Northwestern University. He holds the Chartered Financial Analyst® designation and is a member of the Boston Security Analysts Society and the CFA Institute.