A Case for Investing in Europe

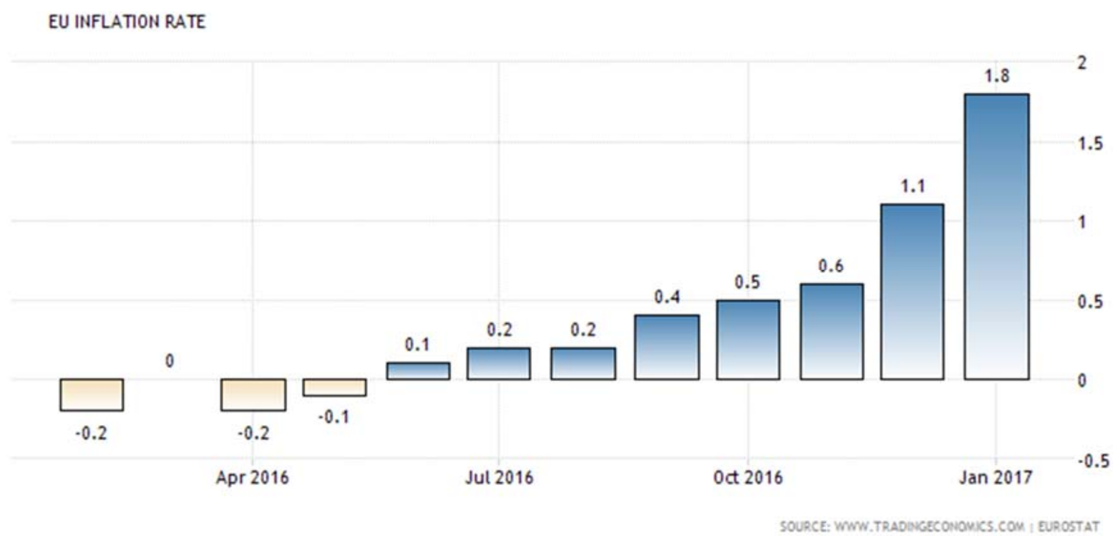
Not just the European economy but the European Union (EU) have both been in the headlines for much of the last few years for mostly negative reasons. The EU area unfortunately has had to face a tough economy, brutal terrorist attacks, and a referendum against it. Despite the fall in energy prices and unprecedented quantitative easing since March 2015, the pace of Europe's recovery has been frustrating. The weakened Euro, driven by negative rates, has also been unable to revitalize the economy and it seems that there will be no letup in the headlines with the upcoming Dutch, French and the German elections. Despite the headline risk, and the healthy skepticism, we at Lynx believe that the upside to the EU economy remains positive. In this paper, we will look at some of the underlying issues that have captured headlines and examine the current growth and valuation indicators to make a rather positive case for investing in EU stocks.

Italy, the EU's third-largest economy, has been a drag on the region because of problems with its banking system, which is burdened with €200 billion in bad loans. This has restricted not only new lending but has created an additional required bail-out in the recent past. It now seems that the growth in bad loan charges might be coming to an end (fig-1). We believe that Italian banks are accelerating the sale of distressed asset backed loans to repair their balance sheets. This should bode well for the economy.

Figure 1

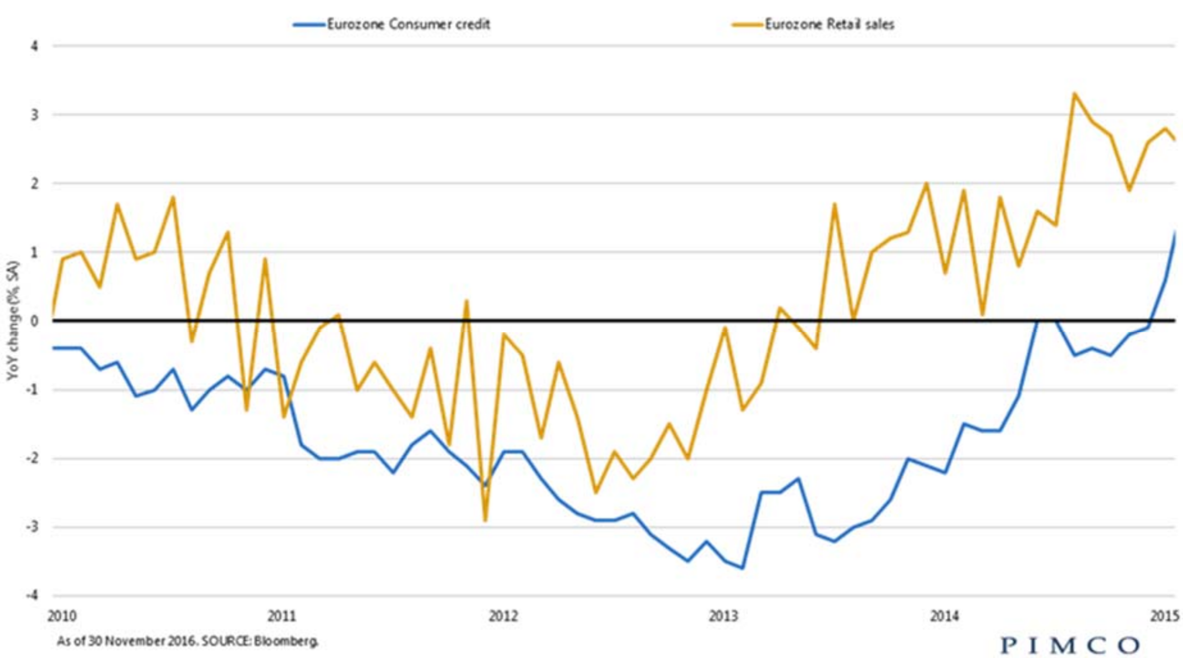
For a long time now the European economy has stagnated with negative inflation rates, prompting the European Central Bank to maintain a zero-interest rate program and purchase both sovereign and investment grade corporate bonds. It now seems that the economy is showing green shoots with inflation at 1.8% during the fourth quarter of 2016 (see fig-2).

Figure 2



Consumer credit and retail sales which had been in negative territory since the crisis first hit in 2010 are now solidly in positive territory, braving Brexit, terrorist attacks, and selective banking crises in 2016 (see fig. 3).

Figure 3



EU GDP has started to grow. In 2016, growth in the Eurozone for the first time since 2008 outpaced the U.S. as EU GDP grew by 1.7% compared to 1.6% in the United States. What is noteworthy is that not only was Germany up by 1.9%, but some of the most problematic countries when the crisis first hit, i.e. Portugal, Ireland, Greece, and Spain, have experienced strong recoveries. Spain's GDP expanded by 3.2% last year and Ireland clocked in at 4%.

At times a good economy does not necessarily mean good capital market returns. Equity markets depend not only on earnings growth but also on valuations. The valuations in Europe, as measured by price to book ratios, also are much cheaper than in the United States. While the U.S. trades at 2.8x book value, Europe trades at 1.7x book.

So, how should an investor invest in Europe? A cheap and efficient way to invest in Europe is through an index. At Lynx, we especially like the ETF WisdomTree Europe SmallCap Dividend Fund (Ticker: DFE*), which gives an investor unhedged equity exposure to high dividend paying, European small cap companies. The ETF currently yields 3.9% and carries a 58 basis point charge.

In summary, while both real and headline risks remain in the EU economy, we believe that the region is now trending in the right direction. Aiding our investment thesis is a set of attractive valuations, which support our recommendation to add modest European exposure, most likely derived from a US equity allocation, for those investors with a long-term horizon and ability to withstand volatility.

*Please be aware that some of Lynx's advisory clients currently hold DFE

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