Petercam | Institutional Asset Management

Petercam Equities Europe/Euroland

Update | March 2015

European equities: full of potential

European equities benefit from several tailwinds, including lower oil prices, favourable exchange rates and the ECB's QE policy. But in the end, it's the fundamentals that count.

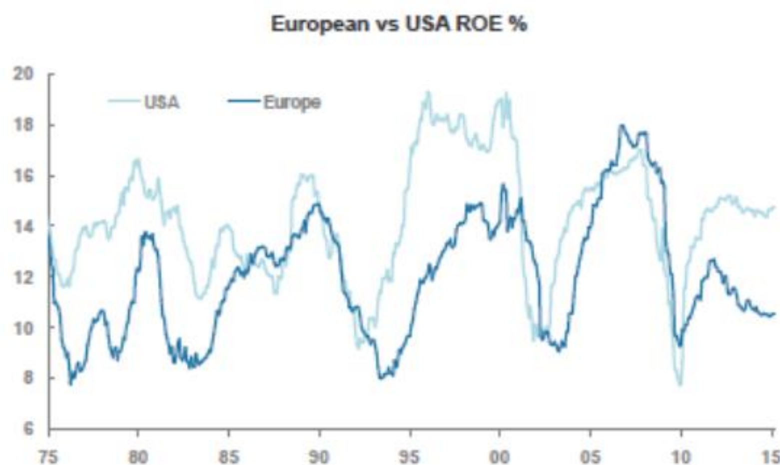
Earnings growth expectations

The first reason for our bullish stance can be found in **earnings growth expectations**.

With over half of STOXX Europe 600 companies having reported results for the fourth quarter, 60 percent have beaten or met revenue expectations, Thomson Reuters Starmine data shows.

Forty five percent of companies beat expectations, and 27 percent have missed, resulting in a net beat of 18 percent - the biggest proportion of "beats" for 10 quarters, UBS said. We expect this positive trend to continue in the next few quarters.

As investing is also a relative game, we believe Europe has some catching up to do versus US equities in terms of ROE (Return on Investment). There is still a gap which we expect to become smaller in the future.



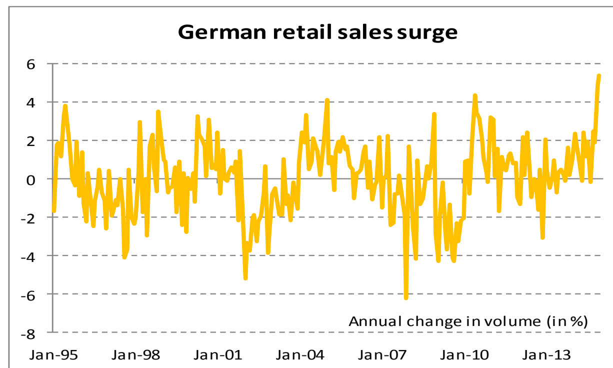
Source: MSCI, Morgan Stanley

Eurozone fundamentals improving

The second reason is the **improving economic backdrop** in the Eurozone. We expect to see positive results from the ECB's QE programme, which started in earnest early March.

Moreover, the credit mechanism is showing signs of life again. On the back of ultra-low interest rates credit demand has been picking up, and actual credit growth has also been improving substantially. In the past this was a clear indication of increasing domestic demand.

All in all, the Eurozone is on track for 1 to 1.5% growth. Consumers in the Eurozone are also growing more confident. A recent indication has been German retail sales, which picked up substantially.



Source: Petercam Institutional Asset Management

EUR/USD weakness

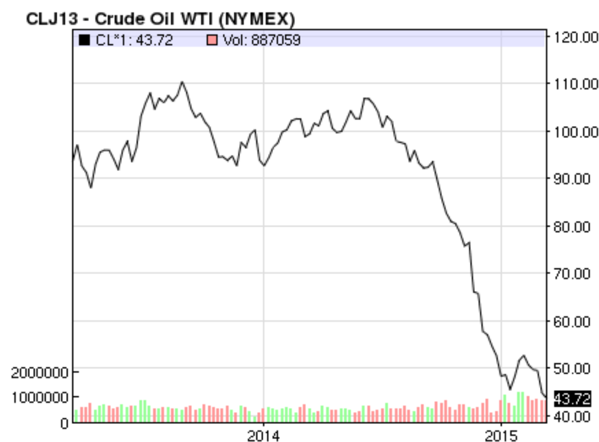
The third reason is the **declining EUR/USD exchange** rate. At the time of writing, the EUR/USD is flirting with the 1.05 threshold.

We do expect the EUR to further weaken and reach parity somewhere this year. In 2016/2017, the EUR may fall below parity versus the USD. This is a boon to European exporters, which become a lot more competitive on a global scale.

Remember that for every 10% EUR/USD decline (trade weighted), EPS of European companies are upgrades by 5%.

Declining oil prices

The fourth reason is to be found in **slumping oil prices**, which have slumped about 50%. As Europe imports a lot of oil, this is beneficial to corporates and households, which see purchasing power increase significantly.



Source: NASDAQ

Discount versus US equities

The fifth reason is the discount European equities are still trading on a **discount versus US equities**.

This can be seen from the graph below. We do believe the **reversion to the mean** mechanism on financial markets is one of the strongest predictors for future performance. Also in that regard, European equities have catching up to do.

Source: MSCI, Morgan Stanley

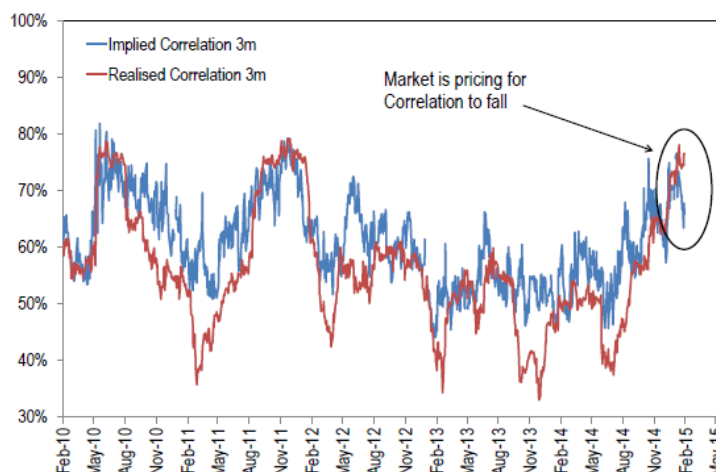
Overweight in our Asset Allocation framework

How does active management and stock picking figure in all this? Our management style has focused on identifying strong business franchises which have been undervalued and under-researched by the markets. In other words, we aim to exploit market inefficiencies by means of in-depth research.

In recent years, market participants have been increasingly investing in European equities through passive instruments (ETFs, trackers). However, recent research has demonstrated that the implied correlation for the Eurostoxx is falling. This is a gauge for where the market thinks stock return correlation is heading.

Realized correlation has been increasing all through 2014, and by and large implied correlation has been tracking this series. However, recently there has been a sharp fall in the implied series, suggesting that the market is **positioning for return correlation to fall**, hence **dispersion to increase**.

So in contrast to the recent macro volatility and high risk aversion, this could be read as a positive for future active stock selection – low correlation, high dispersion is generally **good for active managers** like us.



Source: Citi Research, Citi Global Markets

Aren't there any **risks**? Of course, as always. Balance sheets in Europe are very strong, and operational leverage is high. Valuations are not extremely low anymore.

In other words, some good news has already been priced in. Also, a new Eurozone crisis may put a spanner in the works.

Still, in an overall asset allocation framework, we believe European equities have a lot going for them and we are **overweight** this asset class.

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