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Markets

EuroView: Rotation, earnings recovery and a view from the US

Rory Bateman discusses key themes in European equities, including the rotation towards value, prospects for corporate earnings, and the investment implications of a Donald Trump presidency.

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Rory Bateman

Head of UK & European Equities

Current themes look set to continue

There were a number of unpredictable events during 2016 which the equity markets took in their stride. Volatility around these major political events created opportunities for investors and we believe this may well be the case again in 2017.

We say this not because the politics are unimportant but because the backdrop for the global economy - the key driver for equities - is robust and improving, particularly given the likely stimulative effects of the new Trump administration.

Closer to home, lead indicators for the European economy are strong and corporate earnings look set to grow at their fastest rate for five years. Valuations remain attractive relative to history and other developed markets. We expect the recent thematic rotation towards value will continue given the more optimistic outlook and pick-up in bond yields.

Strong Q4 for European equities

The European market delivered good returns in Q4, up 5.5% in local currency, driven by a continuation of the value recovery trade which gathered momentum after Donald Trump won the US election. Bond yields have been rising since the third quarter as inflation expectations picked up, driven by higher oil and commodity prices and the more favourable growth outlook.

For the quarter, the market was little changed in US dollar terms given the 6% appreciation of the dollar versus the euro as the US interest rate cycle turned. This is expected to continue given Trump's expansionist agenda. At the sector level, energy and financials were strongest, followed by materials. Consumer staples and utilities performed poorly, both down 10% versus the market.

Energy and materials were the best performing sectors for the year while telecoms and healthcare fared the worst.

At the country level, Italy performed very well in Q4, up 17.6% after a rally that followed Matteo Renzi losing the constitutional referendum. Much of the 'bad' news and uncertainty was already in the price. Despite the Q4 rally, Italy remained the worst performing country for the year at -6.5%, the only declining market in Europe last year. France and Germany performed well with total returns of 8.9% and 6.9%, albeit with all the return coming in the fourth quarter.

While the FTSE 100 was strong in sterling terms (up 19.1%) the appreciation was much more modest in euros at +2.8% for the year or +5.7% for Q4.

Value versus growth

In the second half of 2016 we saw a reversal of fortunes for quality growth companies, initially driven by the pick-up in inflation expectations following the increase in energy and commodity prices.

In addition, the Trump victory has been taken well by the equity markets given his reflationary and expansionist commentary throughout the election campaign. The importance of gaining an understanding of exactly what's going on in Washington cannot be underestimated as we try to navigate the markets over the coming year.

To this end, our very own David Docherty, a core portfolio manager from our Pan European team, has just spent a week on Capitol Hill meeting with officials and policymakers to give us a valuable insight into Trump's intentions. We have a separate section later in this review which details his findings.

The 5-year/5-year chart above shows how inflation expectations have picked up and the chart is similar for bond yields, particularly in the US. Rising yields suggest increased economic activity and are typically beneficial for cyclicals and financials given improving pricing power for economically sensitive companies and increasing interest rate spreads for banks.

These sectors have been positioned firmly within the 'value' camp which explains the recent underperformance of quality growth stocks. We believe this trend is likely to continue through 2017 and therefore, as we've highlighted before, the extended valuations of sectors such as consumer staples are likely to compress relative to banks and other cyclicals.

Point of maximum uncertainty

The Warren Buffett adage 'be greedy when others are fearful' would have served investors very well during 2016 and we believe there will be plenty of volatility - and thus opportunity - during 2017. The following charts highlight the market's behaviour during three political events last year: namely the UK's referendum on EU membership; the Italian referendum on Renzi's constitutional reforms; and the US presidential election.

In each case, the subsequent market reaction (despite the very unpredictable outcomes) was favourable for investors because the uncertainty had been removed. Given the number of political events in Europe this year, investors may well find that comparable situations arise and we would advise our clients to try to take advantage.

There was substantial market volatility during the EU referendum process, and despite the 'No' vote the UK and European markets quickly adjusted given the uncertainty was over.

The Italian market was a poor performer in the run up to the Renzi referendum. Even though he lost the vote, the subsequent market reaction was significantly positive.

Interestingly, many market participants were predicting a negative market reaction in the event of a Trump victory. We provide more colour on the rationale for the post-election rally below, but despite the already high valuations, the US market moved to new highs after the vote.

European earnings recovery

European earnings for 2017 are predicted to show high single digit growth which would be the fastest rate for five years. Banks and commodity-related stocks should see substantial growth given very easy year-on-year comparatives, whilst other cyclical stocks should benefit from operational gearing in a gradually improving European and global economic environment.

Indeed, earnings revisions have consistently improved over recent months (see charts below) and the momentum from the companies in which we invest looks positive for the coming quarters.

In addition to an improving earnings picture, the one-year forward P/E multiple is in line with historic averages at around 14x. More importantly we prefer to look at longer term valuation measures such as the cyclically-adjusted price-to-earnings ratio (CAPE) which is at near trough levels compared to history.

The chart below also illustrates Europe's relative attractiveness compared to the US which trades at near peak levels. It's a familiar story in Europe where prospective earnings growth and valuations have in the past appeared to offer substantial upside, only to disappoint.

The difference this year is that we have decent visibility on important sectors that are recovering from trough levels. The potential upside for the market is significant if the earnings are delivered along with a possible re-rating which, as we've highlighted, could be driven by the value segments of the market.

The view from the US

The election of Donald Trump will have major implications for global equities so in order to gain a detailed insight into the new Republican administration we sent David Docherty, our core UK Equity fund manager, to Washington DC and New York in early January.

David has a detailed knowledge of American history and takes a keen interest in US politics. He met with a number of policy advisors, financial institutions and analysts and came back with a number of conclusions which will help us frame our investment thinking in the coming months. We will be publishing a more detailed piece on his trip but here are a few key takeaways:

Outlook

The recovery in corporate earnings is likely to be the key factor driving European markets higher this year. The underlying economic recovery is continuing at a slow pace and a number of important sectors such as banks and commodities will see profits recover from depressed levels.

Valuations in Europe remain attractive relative to history and other developed markets which gives some scope for a re-rating on top of the earnings improvement.

There are a number of significant political events in Europe this year which will create volatility but we would advise our clients to be opportunistic and try to take advantage of periods of weakness – a strategy that would have served well in 2016.

We live in a dynamically changing world and the new US president will no doubt create opportunities and threats for our investments. As a global firm we use our reach and resources to maximise the opportunity set to generate alpha (outperformance versus the benchmark) for our clients. The recent market rotation clearly demonstrates the dangers around passive, momentum investing where the trade becomes very crowded.

We wish all of our clients a very prosperous 2017.

Read the full report

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