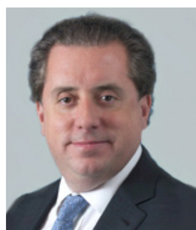
A Closer Look at Europe

"Perception is a guess or estimate of what is 'out there' depending on how we read the clues...."[1] When it comes to investing in Europe in 2019, we've left guessing far behind, turning to fixed income and equity experts who know the facts, character and nuances of the region. David Zahn and Katrina Dudley talk about what lies ahead, what's important to know as the year unfolds.



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Q: What's your sense of the current investment environment?

David Zahn: From a fixed income perspective, this is an interesting time as compared to the last few years where it's been quite difficult to make money in European fixed income. Over the next 12 to 18 months, investors will have to be careful, but I do think there will be opportunities for positive returns. It's worth reminding Canadian investors that Europe's fixed income landscape is incredibly varied, offering considerably more opportunity within the space than you'd expect from a normal fixed income market.

It's always unwise to look at Europe through the same lens as you would North American markets, as you'll wind up with a completely wrong view. For instance, economic growth in Europe will always be lower than in Canada and the United States for various reasons. We're likely to see the pace slow to below 2% in 2019; however, at that rate the region will still be growing at, or above potential. While interest rates have been climbing, getting closer to normal in North America, we expect the near opposite in Europe. The European Central Bank did end its quantitative easing (QE) program in December, but we believe fundamentals such as an aging population, political uncertainty, lower growth and sticky, low inflation will keep interest rates in the region low for a much longer period of time.

As the interest rate differential between Europe and North America widens, we think US assets will likely become less attractive to European investors and we could see capital migrate back. We also expect investors in other currencies to look at buying European assets and possibly hedging them back, which would make things interesting.

Katrina Dudley: As equity investors, we also treat Europe as a very distinct market from North America. Over the last few years, we've seen wide-sweeping contraction of P/E multiples and markets are pricing in recession. Yet, there are currently no significant signs of market excesses, which could contribute to a big end of cycle. Looking at 2019, we expect earnings growth to slow, but remain positive overall. Often, people don't realize that Europe had an earnings downturn as recently as 2015, so we're not benchmarking to the 2008 financial crises. This market is not as long in the tooth as many assume and we believe there's still some upside potential for 2019.

We may see more companies return capital through share buybacks. European firms are increasingly pursuing this step, but nowhere near the pace of US companies. Or, we could see increased merger and acquisition activity as firms look to generate incremental earnings growth from merger synergies.

Q: What are your thoughts on recent volatility?

Katrina Dudley: As with other markets, volatility in the region is coming off historical lows. Though the ride can prompt uncomfortable feelings, looking at the EURO STOXX 50 Volatility Index, it's back to its five-year average. As longer-term

1. "Perception Sayings and Perception Quotes–Wise Old Sayings," http://www.wiseoldsayings.com/perception-quotes.

investors, working with a three- to five-year investment horizon, we view it as a return to normal.

David Zahn: We're seeing volatility return as QE initiatives wrap up worldwide. Keep in mind, central bank monetary policies of the last decade helped repress volatility. Now that's changing and things are choppy. Volatility is advantageous as our active management approach is well-matched to making money in this kind of environment.

Q: Political uncertainty remains a major theme. What should we be mindful of?

Katrina Dudley: From a purely investment standpoint, we see 2019 as a year of growing resolution, potentially providing markets with some welcomed clarity. Italy, for instance, appears to have reached an amicable agreement as to the budget deficit it can run. Germany's government has long relied on a grand political coalition. Though Angela Merkel stepped down as leader of the Christian Democratic Union at December's end, we don't expect a big deviation in the coalition approach. France continues to introduce structural reform and while December's riots in Paris made headlines, we don't believe such pushback will derail France's entire economy. In terms of Brexit, we do know the date of resolution is March 29, 2019 and believe there will be an agreement closer to that time.

Potential Brexit implications are an ongoing part of our analysis of European stocks. While there's a lot of important news on the United Kingdom's (UK) walk towards divorce, we think it's imprudent to ignore the other side of the situation. Looking at the EU27 (the remaining countries) we're seeing a region much more focused on political cohesion, which will help over-ride financial concerns. We've also seen heightened anxiety among consumers and businesses dampen spending. With some certainty on various fronts and no surprises, 2019 could bring pent-up demand back into the market, sparking increased spending. This would be good news.

David Zahn: It's also critical to look at the resulting significant change to the European Parliament's composition. Germany, the UK, along with a few smaller countries, have traditionally supported austerity policies, voting to keep spending under control. With the UK gone, we'll see a more pro-eurozone (those countries using the euro), pro-spending parliament. Even though a great number of these countries have a high debt-to-GDP ratio, it's likely only to go up. This is significantly different than what we've seen in the past. You don't get this type of event often, fortunately.

Q: Where are you currently finding opportunities?

David Zahn: We have an overall preference for government bonds, given the depth and dynamic nature of the options available to us. Italy, for instance, is one area offering value for investors. There are political issues, but the government is increasingly more realistic and we expect they will make a deal with the eurozone. Recent sell-offs in investment grade credit are opening some doors. Noting that European high yield bonds are generally of a higher-rated quality than similar options in North America, we also like some options there.

Katrina Dudley: Growth themes, such as Luxury stocks in Europe, have been centre-stage for some time now. As deep value investors, our approach is not so thematic. It's about identifying cheap stocks—those left behind in the midst of growth themes—that are not value traps.

Two examples are NN Group N.V. and Accor SA. The former is a Dutch/European insurance firm with a strong balance sheet and one of the strongest solvency ratios in the region. While the market is generally ignoring European insurers at the moment, we've identified several catalysts that will enable NN Group to create value for investors over the next several years. Accor, perhaps best known to readers for their 2018 acquisition of Fairmont Hotels, has historically been a large owner of economy hotels in Europe. The firm's strategy has evolved in recent years—expanding their portfolio range from ultra luxury to low frills, while modernizing their business model. Accor has been gaining share in core countries and emerging markets. We believe Accor's story is underappreciated and the company is well-positioned within the global hospitality sector.

Looking ahead, the stories of these two undervalued stocks aren't dissimilar from current market sentiment, which is ignoring fundamentals that say 2019 could well offer a positive next step in European markets, not the cycle's end.