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From Australian to US to European shares – reasons to be optimistic on Eurozone equities

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Key points

> While Australian shares remain in a longer term period of underperformance relative to global shares and US shares are also relatively vulnerable in the short term to Fed rate hikes, European shares look attractive.

> Eurozone shares and growth assets generally are likely to benefit from a combination of aggressive monetary easing, the lower Euro, stronger economic growth and attractive valuations.

Introduction

Despite all the doom laden commentary regarding the Eurozone, it has not only hung together since the Eurozone crisis first erupted in 2010 but expanded from 17 members to 19. Countries want to get in not out! And so far this year Eurozone shares are star performers, gaining around 14% compared to 2.6% for global shares (in local currency terms). This note takes a look at why Eurozone shares are attractive particularly against Australian and US shares.

Constraints for Australian and US shares

For some years our view has been that Australian investors should consider having a higher weighting in global shares relative to Australian shares, compared to what they might have had a decade or so ago. While I am not in the bearish camp regarding the Australian economy and I love the franked dividends Australian shares pay, the reality is that the commodity/resources cycle has gone from being a tailwind to a headwind for the Australian economy. With this the $A is likely to fall further which will serve to enhance the returns from unhedged global shares and after the outperformance last decade, Australian shares remain vulnerable to a bout of mean reversion against them.

The rebound in the Australian share market this year has not changed this view. If anything, it has left the Australian share market vulnerable to a correction. Looking beyond that I am not bearish on Australian shares but see the period of relative underperformance versus global shares that has been underway since 2009 continuing.

But having made the decision to allocate more equity funds to global shares one naturally wonders whether the US share market is also a bit vulnerable in the short term. The US economy has led the way out of the global financial crisis (GFC) and looks solid and I remain of the view that US shares have entered a new secular bull market.

However, since the GFC low US shares have outperformed global shares by around 34% and this outperformance is at risk of some reversal. On several valuation measures US shares are relatively expensive compared to other global markets and history tells us that the period around the first Fed monetary tightening can cause volatility. This was the case around the time the Fed last started to raise rates after major easing cycles: in 1994 (which was associated with a 9% correction in US shares) and in 2004 (associated with an 8% correction).

While Fed tightening may cause volatility and US shares are not overvalued if low bond yields are allowed for, it's worth noting that valuations for non-US global shares remain attractive whether or not low bond yields are allowed. For example, while the so-called Shiller price to earnings multiple – which compares share prices to a rolling ten year moving average of earnings to smooth out the earnings cycle – puts US shares at 26 times, global shares excluding the US are only trading on 15 times. This measure, which is often referred as a cyclically adjusted PE (or CAPE), is shown in the next chart.

Source: Global Financial Data, AMP Capital

In fact, global shares ex the US are about as cheap as they ever get on this measure and whereas the US is edging towards monetary tightening with higher interest rates, the predominant trend in the rest of the world is still towards monetary easing. This tells us that there are still plenty of opportunities in global shares for investors (even if there are worries about the US share market) and a major one of these is Eurozone shares. There are others - but since that is our favourite I'll focus on that in this note.

Five reasons for optimism regarding European assets

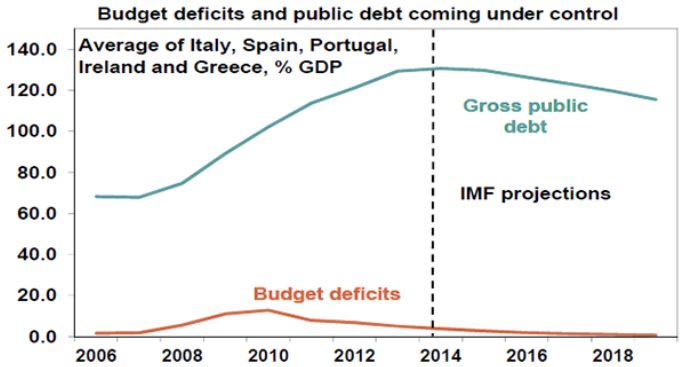
There are basically five reasons for optimism regarding Eurozone shares. **First, the Euro is here to stay**. Yes it has not fully delivered the economic benefits originally espoused for it, but each crisis over the last five years has seen "more Europe, not less". Who would have thought that Germany

would support a bailout fund across Europe that could potentially expose German taxpayers or a central bank engaged in money printing. But that's what we now have. And 70% of Greeks want to stay in the Euro not exit which is why there is all the pressure on the new Greek Government to compromise. What many miss is that the Euro is the culmination of a 60 year political project motivated by a desire for European strength in an unstable political world.

While many fret that radical anti-Euro parties are on the rise, the reality is that after six years of economic pain they haven't really done that well. Spain is really the only country to watch given the rise of far-left Podemos, but its election is not until December and by then support for Podemos may have faded.

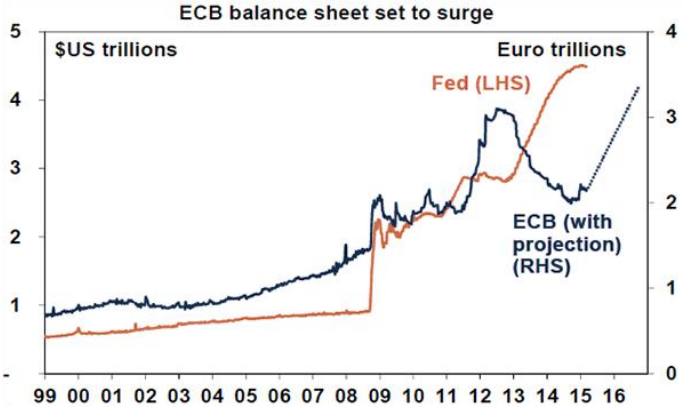
This all means that the risk premiums attached to assets in some peripheral Eurozone countries will continue to decline over time.

Second, the troubled Eurozone peripheral countries are now in better shape with lower budget deficits, peaking public debt to GDP ratios and improved competitiveness (see Greece and the ECB – is the Eurozone crisis about to make a comeback?, Oliver's Insights, January 2015).



Source: IMF, AMP Capital

Thirdly, monetary conditions are easing aggressively with the ECB running negative interest rates, engaging in a broad based quantitative easing program involving the purchase of €60bn in debt securities a month and the Euro having fallen to its lowest level since 2003. This is in contrast to the US where QE has stopped, the Fed is getting closer to rate hikes and the $US is at its highest since 2003. At the same time Eurozone fiscal austerity has slowed.



Source: Bloomberg, AMP Capital

Fourthly, helped along by monetary easing, reduced fiscal drag and lower oil prices Eurozone economic conditions are looking up. The December quarter saw a slight pick-up in GDP growth, but more importantly confidence and business conditions PMIs have improved and bank lending has picked up. Eurozone growth could push up to 2% this year – which is pretty good for Europe.

Source: Bloomberg, AMP Capital

Finally, Eurozone shares are unambiguously cheap trading on a cyclically adjusted PE of 14 times compared to 26 times in the US. See the first chart. This is partly reflective of Eurozone shares having significantly underperformed US shares since the GFC low point back in 2009. See the next chart.

Source: Bloomberg, AMP Capital

Since the GFC low US shares are up 202% whereas Eurozone shares are up only 116%.

What about Greece?

Risks remain around Greece as it has yet to unlock funding agreed as part of the 4 month extension of its existing loan program and will then have to agree a longer term program. Despite the risk of political instability in Greece itself, as Syriza struggles, our view remains that a 'Grexit' is unlikely as amongst other things 70% of Greeks want to stay in the Euro. More significantly though, there has been zero flow on to other peripheral countries through the recent bout of Greek uncertainty as they are now much stronger and ECB bond buying is keeping their bond yields down. So even if there is to be a Grexit it's unlikely to destabilise other Eurozone countries.

Implications for investors

There are several implications for investors. First, there remains a strong case to favour global over Australian shares on an unhedged basis for Australian based investors.

Second, while US shares may be a bit vulnerable to a bout of global underperformance, particularly as the Fed moves closer to raising interest rates, there are plenty of attractive opportunities outside the US for investors.

Thirdly, on this front Eurozone shares stand out as attractive: they are cheap, the economy is improving and this will help profits and monetary conditions are easing. The same is likely to apply to Eurozone commercial property and infrastructure.

Finally, while the Euro may remain under downwards pressure against the $US, any fall against the $A is likely to be limited with the RBA set to ease further. So currency is not a major issue for investors.

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