A contrarian moment

Share prices in Europe may have priced in the bad news

EUROPE is an ageing continent, ruled by squabbling politicians, made soft by generous welfare programmes and saddled with an unworkable currency regime. That caricature seems to fit with the general impression of international investors, who have been deserting the continent’s equity markets. Morningstar, a research firm, says that euro-zone large-stock funds have suffered 14 consecutive months of outflows. Since the start of 2010, when Greece’s debt problems started to become clear, European shares have dropped by 18% and America’s have risen by the same amount.

But even if the European growth outlook is sluggish and no clear end to the debt crisis is in sight, there comes a point when all the bad news is reflected in the price, and contrarians should turn bullish. That point may have arrived. Matthew Wood, a hedge-fund manager at Lancaster Investment Management, regards current European share-price levels as “an extraordinary value opportunity”.

Many investors will be reluctant to take the plunge until the outcome of the Greek election on June 17th is known, for fear that the aftermath may be complete chaos. It would be a brave man who plunged into the Athens stockmarket, even though it has fallen by 90% from its peak. You might buy a share denominated in euros and end up owning a security denominated in devalued drachmas.

Europe has many world-class companies that sell goods and services across the globe and that are not dependent on the fortunes of peripheral members of the euro zone. Robert Buckland, an equity strategist at Citigroup, points out that about 44% of pan-European corporate profits are generated outside Europe (British companies earn 52% of their profits outside the continent). Around 24% of European profits come from emerging markets, roughly double the exposure of American companies to the developing world.

This diversification is not a coincidence. European companies have already endured a decade of sluggish growth and have sought out markets elsewhere (for production as well as sales). If slow growth continues, they are likely to diversify even more.

In short, buying a stake in a European multinational is not the same as making a bet on the European economy.

What’s more, the work of Elroy Dimson, Paul Marsh and Mike Staunton of the London Business School has shown there is no statistical link between one year’s economic growth and the next year’s stockmarket returns. For the period from 1972 to 2009, the trio ranked 83 countries by their GDP growth over the previous five years. Investors who backed the slow-growth countries earned better returns than those backing the high-growth group.
That is because what tends to matter most for investment performance is the initial valuation. When valuations are low, the odds shift in the investor’s favour. When they are high, the odds are against. That is clearest in the bond market (those buying German two-year bonds on a yield of zero are assured of exactly that return) but it applies to shares as well. Everyone was enthusiastic about equities in the late 1990s, so valuations reached giddy heights; subsequent returns have been low.

European shares are not at their cheapest ever, but they look relatively attractive. In the core markets of France, Germany and the Netherlands, the dividend yield is much higher than the yield on cash or on ten-year government bonds. The average dividend yield on European shares is 4.1%; the American market offers a yield of only 2.2%.

Ian Harnett of Absolute Strategy Research, a consultancy, says that European equities are trading on a cyclically adjusted price-earnings ratio—a measure that averages profits over seven years—of 11, towards the bottom of its range over the past 30 years. By contrast, the ratio for American shares is 18.1 (see chart). Wall Street generally trades at a premium to Europe but the premium today is more than three times the historical average.

Simply being cheap is no guarantee that European equities will rise in the short term. There is the risk that the euro zone will break up in chaos and that a deep recession will ensue. But if that did happen, other equity markets would be dragged lower as well. If European dividends merely keep pace with inflation, the long-term real return on equities will be 4%. In a world where the real risk-free rate in many developed markets is close to, or below, zero, that is an option worthy of serious consideration.