Europe's Fragile Recovery
September 16, 2013
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Investors have tentatively begun to buy into the European recovery story, but remain fearful of the region's fragility. A few bits of upbeat economic data recently have provided grounds for optimism, and the European Central Bank's continued commitment to holding the Eurozone together has boosted confidence. Tucker Scott, portfolio manager for Templeton Foreign Fund, still sees a few economic roadblocks in Europe but also plenty of progress. He shares where he’s finding signs of strength – and investment opportunities.

I think it's fair to say Europe is in the early stages of recovery from its recession, one that has been much deeper and longer than the one in the US. Eurozone GDP expanded by a better-than-expected 0.3% in the second quarter of 2013 over the first quarter, which could potentially mark the end of an 18-month recession in the region. In my view, the biggest risk to Europe today is backsliding into crisis mode, which would undercut some of the nascent signs of recovery we see in place.

Reasons for Optimism in Europe

A recovery appears underway in Europe for a number of reasons, and like many recoveries, once it gains momentum it could be self-reinforcing. Consumer confidence in the Eurozone has grown for several months in a row, after bottoming late in 2012. It's still at a low level but is improving, and I think that's a key harbinger of broader economic improvement. In the second quarter of 2013, retail sales in the Eurozone turned positive for the first time in two years on a quarter-over-quarter basis. Additionally, industrial output in the Eurozone rose during the second quarter at its fastest pace in more than two and a half years.

A very important point to make from an investment perspective is that corporate profitability in Europe today is well below what some market participants, including ourselves, believe should be normal levels. This is tied to the economic cycle. Europe decoupled from the US in 2011. When the US started to recover from the financial crisis of 2008 – 2009 triggered by subprime loans there, Europe didn't really follow suit, facing a sovereign debt crisis of its own. Because Europe has been in a much deeper recession, corporate profitability in Europe has suffered quite a lot. We estimate that over-the-cycle, normalized profits would be about 30% higher than what European corporates are expected to earn in 2013.

The fullness of the recovery that's underway in the US means corporations there are earning near
normal levels of profits. The market puts a price-to-earnings (P/E) multiple of 15 times on the US market, but is only putting a 12 times P/E multiple on Europe’s already-weak earnings. Thus, the market is not pricing in a recovery in European profits when that would seem to be a probable scenario. We believe European stocks are positioned to outperform via superior earnings growth if a recovery unfolds, as we expect, and Europe might further outperform by meritng a higher P/E ratio on those higher earnings. We believe the combination of earnings returning to more normalized levels and a P/E in line with the US could help European equities outperform US equities over the longer term.

While it’s certainly easy to bash Europe given the difficulties that it has experienced recently, we think it’s much more important to look at its long-term track record. If you look at total shareholder returns going back to 1969, holders of European stocks have actually modestly outperformed holders of US stocks, and dividend growth in Europe has actually been quite a bit better than dividend growth in the US.¹ Today, average dividend yields on European stocks are 4.2%, almost twice that of the US, at 2.2%.²

So on trough earnings, investors are currently paying a discount to own European stocks. If the recovery is underway, or when it comes (which I believe it will), I think European stocks have significant performance potential built into them.

**Flexibility and the Fed**

When the earnings recovery in Europe comes, I think investors will be surprised by its strength. This has everything to do with the nature of the European economy versus more flexible economies like the US. In Europe, there are certain fixed costs built into the system that can make it more difficult for its economies to adapt to a changing environment, and it can also cause a delay in recovery as well. For example, the labor market is not as flexible in some respects; it’s much harder to fire people in some countries. What this basically means is that the operating leverage of Europe is higher than that for a more flexible region, so in a downturn profits can suffer disproportionately in Europe. But I think people are forgetting—and what the market is not pricing in today—is that, in a recovery, operating leverage works in the other direction and we could see a very sharp pick-up in profits.

Just to give you a sense for the excess capacity that exists today: Italian new car sales over the last four years have been running at just half the level they were at between the years 2000-2010. That’s a significant drop. If you look at Capital Expenditures (Capex) to GDP³, it’s currently near an all-time low in Europe. An increase in output, when it comes, could disproportionately boost profits. As sales begin to grow in a firm with excess capacity, few incremental costs are associated with the higher sales and most of the increase comes through as profit.

The prospect of the US Federal Reserve “tapering” its asset purchase program has been communicated as data dependent, so I think that is the key; the tapering will likely only occur amid a strong and broad US recovery. However, I don’t think it’s going to be a big disruptive force in the long term. We currently have accommodative monetary policy in both Europe and in Japan, so all the large monetary authorities in the world are in stimulative mode and running very low interest rate policies. In the case of Europe, the economy has been held back to some extent because it hasn’t had the same luxury of fiscal stimulus the US has had. Austerity measures in Europe have kept fiscal stimulus to a minimum, but I believe that as austerity begins to ease a little bit, that factor could diminish.
The Investment Case

When we think through the economic cycle and where European profitability ought to be on a normalized basis, we see a lot of interesting stock ideas in Europe. For the last two years we have favored financials, energy and healthcare in Europe.

An example in the European financial space that we like is ING. The core of ING is a bank, but it also has insurance businesses around the world, which it’s in the process of selling off. We think its insurance disposals could potentially generate close to €10 billion, and its market cap today is about €30 billion. This is a bank with a long-term record of profitability, recently trading at roughly half of tangible book value. ING represents the kind of value that we find attractive today in Europe.

If you look at bank valuations historically, they have rarely been below 0.7 times book value, and last summer they were at 0.5 times tangible book. That’s below where US banks traded during the Great Depression in the 1930’s and below where the British banks traded in the 1970s, when nationalization was hanging over them.

Also in Europe, we have been interested in several large integrated oil and gas companies, such as Total in France and Shell in the UK. We think these are neglected stocks that are cheap, both trading...
under nine times earnings currently. What’s interesting to us is that these companies could be significant beneficiaries in a higher energy price environment than where we are today, and this does not seem to be reflected in current valuations.

What are the Risks?

All investments involve risks, including possible loss of principal. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors. To the extent the Fund focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a fund that invests in a wider variety of countries, regions, industries, sectors or investments. Current political uncertainty surrounding the European Union (EU) and its membership may increase market volatility. The financial instability of some countries in the EU, including Greece, Italy and Spain, together with the risk of that impacting other more stable countries may increase the economic risk of investing in companies in Europe. The fund’s risk considerations are discussed in the prospectus.

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2. Ibid.


4. As of 6/30/13, ING Group NV represented 4.21% of total net assets of Templeton Foreign Fund. Holdings subject to change without notice.

5. Source: Bloomberg, LP as of 6/30/13.

6. As of 6/30/13, Total SA represented 1.46% of total net assets of Templeton Foreign Fund. Holdings subject to change without notice.

7. As of 6/30/13, Royal Dutch Shell represented 1.52% of total net assets of Templeton Foreign Fund. Holdings subject to change without notice.

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