April 24 2017

EUROPE ENTERS THE TOUR DE FRANCE

Burt White *Chief Investment Officer, LPL Financial*
Matthew E. Peterson *Chief Wealth Strategist, LPL Financial*

KEY TAKEAWAYS

Though political considerations have dominated the conversation around European investing (for good reason), fundamentals are the main driver.

Europe has emerged from its earnings recession, and expectations for 2017 appear optimistic given the economic fundamentals.

European election results that do not roil markets and decent earnings expansion in the first quarter will be key for further European equity strength.

The next four weeks will be a major turning point for European investors. France is in the middle of what is arguably its most important election cycle since World War II. The results of the second round of presidential elections, as well as parliamentary elections scheduled for mid-June, will determine if France maintains its historical position as one of the primary advocates for European integration and identity or if anti-European candidates garner additional power. France is both literally and figuratively at the center of Europe, and the concern that it will become more anti-European may be having greater impact on the markets than is apparent at first. Even with pressing political issues, it's important not to overlook corporate fundamentals, which have also been seeing a meaningful reversal. European corporate earnings experienced a strong rebound at the end of 2016, with consensus expectations from Thomson Reuters of another 20% increase over 2017. These are optimistic forecasts, and though certainly possible, combined with the political uncertainty has kept LPL Research from recommending European equities on a tactical basis.

OVERVIEW

As of last week, European stock performance in 2017 has essentially equaled that of U.S. stocks, near 5%, based on the Euro STOXX 50 and S&P 500 indexes. Within the region, cyclical and growth stocks, such as biotechnology and industrial companies led the rally. Companies generally considered "value" stocks, most notably traditional banking, as well as chemicals and other basic resources, underperformed. The worst performance, both relative to the rest of the market and on an absolute basis, was the energy sector, particularly companies involved in oil and gas exploration and production.

Investors have been increasing their allocations to European equities according to reports from Lipper, a provider of specialized data on flows into investment vehicles. Nearly $300 billion was added to European investment vehicles of all types in 2016, with inflows estimated at an additional $15 billion early this year. A recent survey of money managers by a large U.S. brokerage firm found that European allocations

Member FINRA/SIPC
LPL Financial

were at a 15 month high. Apparently, many investors were not worried the upcoming election. Neither is the equity market itself if we simply look at its recent historical volatility [Figure 1].

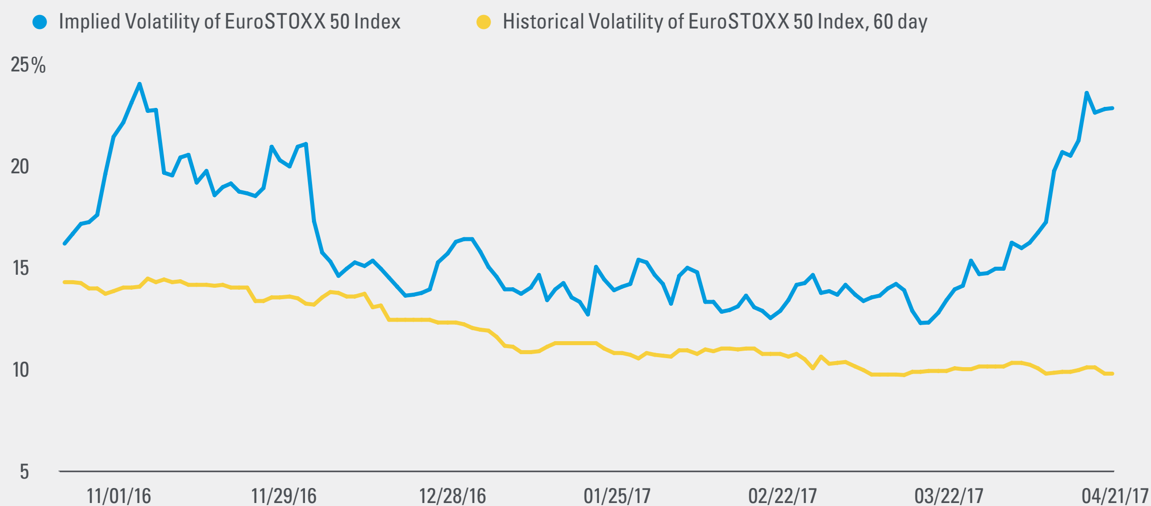
However, Figure 1 also shows that there is a different story underneath the surface. Some traders, particularly larger institutional ones, may have been looking to hedge their portfolios (a strategy that attempts to reduce risk while still maintaining meaningful upside exposure in case the market rallies) by buying a form of portfolio insurance through the options market. The cost of this insurance is determined by the "implied volatility" of options on a stock or stock index, in this case the Dow Jones Euro STOXX 50 Index, an index of major European companies. The rise of implied volatility suggests that investors believe that there may be a significant movement in stocks, but the direction is unknown, and presumably will hinge on the results of the upcoming elections.

EARNINGS TO THE RESCUE?

The European equity markets broke out of what had been referred to as an earnings recession, or even an earnings depression in the back half of 2016. Earnings for the STOXX Europe 600 Index increased 12.6% in Q4 2016, compared with Q4 2015, powered by strong growth in consumer cyclical and energy stocks. However, the bar for 2017 earnings is even higher, with expectations of 7.2% Q1 2017 growth (over Q1 2016) and earnings growth of all of 2017 of nearly 20%. While there is a solid potential backdrop for robust earnings growth we believe this level of growth can be considered optimistic. At the very least, we think it's safe to say Europe needs to have market-friendly outcomes to the political challenges it faces between now and the early fall.

Expectations are highest in the energy sector, where profit growth was negative in 2016 after

1 COST OF HEDGING EUROPEAN STOCKS RISING, DESPITE CALM MARKETS



Source: LPL Research, Bloomberg 04/24/17

Indexes are unmanaged and cannot be invested into directly. Past performance is not indicative of future results.

The EURO STOXX 50 Index is a blue-chip index for the Eurozone, which covers 50 stocks from 12 Eurozone countries: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

Implied Volatility of the EURO STOXX 50 uses options pricing to extract market-implied volatility of the index.

commodity prices plummeted. Despite being negative on the sector, most analysts were too optimistic on earnings, resulting in company performance below what were already meager expectations. As this earnings season approached, expectations for energy companies were actually reduced, increasing the probability of the companies in the sector beating their numbers, which typically causes stocks to rally in response.

The other sector in Europe that must always be watched is financial services, particularly banks, which comprise almost 13% of the STOXX 600 the largest single group in the index (which does not include insurance, brokerage, or other financial services). Banks make up over 35% of the FTSE 100 Index, the primary index of U.K. stocks. Expectations for earnings growth are high, as much as 40% over the course of 2017. Banks (and financial services generally) are the industry that is potentially the most directly impacted by Brexit (the U.K. leaving the European Union) or any discussion of France replacing the euro as it currency. Global investors will listen carefully to bank earnings reports this quarter for indications of whether high earnings growth expectations can be matched.

FREXIT ≠ BREXIT

Global investors may be willing to accept additional risks in Europe based on the fallout, or lack thereof, after the Brexit vote in June 2016. Thus far, there has been no real consensus on whether the U.K. has suffered any ill effects from its decision to leave the European Union. Not enough has happened since the vote, and each side is basically just reiterating the claims made before the June decision.

Importantly, the scenario in which France would leave the EU (Frexit) is very different from the U.K.'s departure. Most obviously, unlike the U.K., France has adopted the euro. If France tries to move back to the franc, as both its far right National Front and some on the far left (who were eliminated in the first round of the presidential election held on Sunday, April 23, 2017) propose, the damage to the European economy could be tremendous. Italy, which must have elections by May, 2018, but could hold them this year, is likely to give its voters similar choices. Since the U.K. retained the pound as its currency, this issue is not relevant for Brexit.

CONCLUSION

Our base case for Europe is one in which voters in France, Italy, and other countries with strong anti-European sentiment reject the more extreme voices within their political system and allow the European status quo to continue (or perhaps allow the current political structures to fix what those voices perceive is wrong with the system). This will allow the markets to focus on economic fundamentals and corporate earnings. Although political stability may not boost earnings, a calmer environment at least will not be at odds with higher earnings. Banks will provide an early test of possible political threats to earnings as formal Brexit negotiations will begin soon. While there may be opportunities in Europe, political risks and high expectations still only have us lukewarm on European investments relative the U.S. and emerging markets. ■

Member FINRA/SIPC

LPL Financial

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Options are not suitable for all investors and certain options strategies may expose investors to significant potential losses, such as losing the entire amount paid for the option.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

All investing involves risk including loss of principal.

INDEX DESCRIPTIONS

Dow Jones Euro STOXX 50 Index is a market capitalization-weighted stock index of 50 large, blue-chip European companies operating within Eurozone nations. The universe for selection is found within the 18 Dow Jones EURO STOXX Supersector indexes, from which members are ranked by size and placed on a selection list.

STOXX Europe 600 Index is has a fixed number of 600 components, among them large companies capitalized among 18 European countries, covering approximately 90% of the free-float market capitalization of the European stock market(not limited to the Eurozone). The countries that make up the index are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Switzerland, Sweden, and the United Kingdom.

The Financial Times Stock Exchange (FTSE) 100 Index is a share index of the 100 companies listed on the London Stock Exchange with the highest market capitalization. It is seen as a gauge of prosperity for businesses regulated by UK company law. The index is maintained by the FTSE Group, a subsidiary of the London Stock Exchange Group.

This research material has been prepared by LPL Financial LLC.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial LLC is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by Any Government Agency | Not a Bank/Credit Union Deposit

RES 5861 0417 | Tracking #1-602311 (Exp. 04/18)

Member FINRA/SIPC

LPL Financial