

Issue #39 - “European Exposure” November 2015

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Economics : [Forget Debt as % of GDP](#) : Forbes
General : [How to stay calm when stressed](#) : TEDTalks

“The real key to making money in stocks is not to get scared out of them.” – Peter Lynch

With resurfacing threats of Greece exiting the Euro, instability with Russia over Ukraine, unemployment rates of 11%¹ and extremist parties on both sides of the political spectrum garnering votes from Amsterdam to Zurich, the Eurozone seems like a risky place to invest. Despite this, the German (Deutscher Aktienindex DAX) and French (CAC40) indexes are up 12% and 15% year-to-date while, for all the hype of its big economic recovery, Dow Jones (US) market is down 1% and the Toronto Stock Exchange (TSX) is down 7.5% year-to-date. This begs the question – as an investor, how are you exposed to the European market?

A Tale of Two Cities

As has been the case in the Canadian stock market, it is the best of times and the worst of times in the Eurozone. In Canada, oil & gas, mining and materials companies have caused the substantial drop in the index, with their sectors down some -19%, -38% and -20% respectively. On the other side of the coin, consumer staples, discretionary and telecoms have produced positive returns year-to-date of +6%, +8% and +8.4%.

The same can be said in the Eurozone where borrowing rates¹, and in some cases company debts² are at all-time lows and dividend rates look particularly attractive when compared to the bond market. Combined with the recent performance of the German & French indexes, it can be easy to overlook the structural changes needed in many European countries before they can be competitive on international markets. In light of this, it is important to contrast the macro, or big picture view, with the micro view to find out what guides are investment policy.

The Macro-economic view

Despite a hard push for austerity, the levels of debt in the Eurozone remain frightening. In France, the world's 6th largest economy, the debt to gross domestic product (GDP) ratio, which compares the level of debt a country owes to its total production capabilities has swelled from 64% to 95% in 7 years.

France now shares more than just its dismal employment rates with other overburdened economies such as Italy and Spain, all three of which have considerable slack in the labour market with unemployment presently sitting at 10.3%, 11.8% and 21.18% respectively.

Despite having tried to keep its economy afloat using the public purse (spending) in conjunction with the European Central Bank's accommodative monetary policy, most of Europe can't seem to get their economic engines firing! Worryingly, there isn't much wiggle room if things get worse. The European Central Bank's target lending rate sits at 0.05% and has already begun to inject money into the system with quantitative easing. These things combined create a nice big warning sign for investors looking to lend to European countries, or to invest in Europe as a whole, particularly those holding an index of all companies listed on the stock market.

The Micro

The tapestry of countries that form the European Union, when examined on a country by country basis or refined every further into a company by company basis can reveal a very different story. Plenty of specialized service and manufacturing firms are taking advantage of the weakened Euro to grow beyond their borders, and finding plenty of traction in the United States among others. Pharmaceutical giants are poised to profit from the continued implementation of Obamacare, while machining firms are taking part in the rebirth of US manufacturing. Beyond the scary headlines, there are companies in the Eurozone that represent attractive investments – the key is to find these companies and capitalize on market movements whenever fear sends stock prices to attractive levels.

How this impacts you

As you are aware, our job is to tactically allocate investments to a various portfolio management teams that we feel will generate for you a disproportionate amount of return for the risks you are taking. Given the above analysis, we feel that stocks will considerably outperform bonds in the Eurozone over the medium and long-term. Further, individual security selection will be crucial to outperformance and so have sought managers that take a company-by-company or bottom-up approach to investing in this market. As such, our clients will find either CI's Black Creek team, or the Global team at Edgepoint doing exactly that – looking for quality company at reasonable prices outside of Canada.

Over the past several years, we have been adding to these positions and are now “overweight” on international equities and will continue to be until we see an appropriate buying opportunity within Canada.

1. KLARENBERG, Kit. “Investing In Europe: The Trust Behind the Headlines” Money.com ; 2015-Sept-07 <http://www.yourmoney.com/investing/investing-in-europe-risks-rewards/>
2. SHMUEL, John. “Making the investment case for Europe” FinancialPost.com ; 2015-Feb-02 <http://business.financialpost.com/investing/making-the-investing-case-for-europe>
3. TRADING ECONOMICS. “France Indicators” 2015-Nov-02. <http://www.tradingeconomics.com/france/government-debt-to-gdp>