



The first quarter corporate earnings season ended even better than the initial reports had indicated. Aggregate earnings for the first quarter rose almost 14%, according to FactSet, representing the most rapid growth since Q3, 2011. Earnings gains were broad based.

Further, the quality of earnings has also improved. Gains were helped by stronger revenue growth and other solid U.S. economic data. Cost reductions were less of a factor. And share repurchases, often used to boost a company's earnings per share, are down substantially this year (18% lower, year-over-year). Share buybacks are criticized by many investors because they support short-term share price gains at the expense of long-term company growth.

Why Europe?

Clearview is an active manager of high quality U.S. stocks, but we will occasionally venture overseas to invest in other developed markets. We may buy the stock of an individual foreign company, or a basket of stocks that represent a single country or region.

Our justification for doing so is that at times investment prospects outside the U.S. may be better than those within our own borders. Readers of our monthly Market Commentaries know that U.S. large cap stock valuations, after an eight-year bull run, are rich and it is increasingly difficult to find stocks that represent good value.

After analyzing a number of developed markets around the world, we found that Europe offers very attractive investment prospects for reasons we summarize below. We bought an initial position in a basket of European stocks in May for many of our clients.



Why Europe?

- First, valuations are attractive for these proven, high quality European stocks, about 20% lower than for comparable U.S. stocks based on commonly used metrics.
- Projected growth rates in U.S. corporate earnings are robust at 11% for 2017 and 12% in 2018, but Europe has that beat. European corporate earnings are expected to grow 18% in 2017 and near that in 2018. Europe has faster earnings growth at a lower P/E multiple. The Price/Earnings multiple to growth in earnings ratio (PEG ratio), which measures how much investors are paying for growth, is half that of the U.S.!
- Eurozone GDP growth is rising from the dead and is expected to grow nearly 2% this year, a little less than the U.S. forecast of 2.3%. Purchasing manager indexes, a leading economic indicator, are strong in many Eurozone countries.
- The U.S. is likely closer to peak profit margins and earnings. European margins have ample room to grow and profits remain about 45% below the 2007 peak.
- European companies have greater earnings leverage to revenue growth than U.S. companies. For example, for each \$1 increase in revenues, profits rise \$1.80 on average for U.S. companies. In Europe, profits rise approximately \$2.80 for a \$1 revenue increase.
- Dividend yields are generally higher in Europe, about 2.4% for the basket of stocks we purchased.

Of course, no investment is without potential pitfalls. Here are a few of Europe's:

- Because currency fluctuations can adversely affect returns, we have chosen a basket of stocks that are partially currency hedged. Hedges raise costs.
- Political uncertainty has recently improved in some countries but can still be a destabilizing force. Europe (EU), much like the U.S., is experiencing growing nationalism and populism but it is too early to predict what this means for stocks.
- Britain's divorce negotiations with the EU could be bitter and cause further conflict in the Eurozone, including other countries wanting to exit which may jeopardize the future of the EU.
- Europe's demographics (older population) could be a drag on future economic growth.
- Insurgent nationalism could cause trade wars and reduce globalization.

In summary, if our bull market is in the 7th or 8th inning as we think, Europe's bull market may be in the 3rd or 4th inning. Both Europe economies and stock prices are on an upward course which we think could last a number of years. Having a position in a basket of European stocks also adds diversification to our clients' portfolios.

Having completed a period of “ZIRP,” or zero interest rate policy, most economists now anticipate interest rate normalization, or rate hikes, to continue over the next several years. As short rates rise, longer dated note and bond yields would be expected to rise (prices fall) as well. And as you can see from the Hedgeye cartoon below there is plenty of room for rates to rise.



Source: Hedgeye illustration.

However, 10-year Treasury note yields have been falling (prices rising) for the past few months from a mid-March high of 2.60% to the recent low of 2.20% (currently 2.22%). Falling note yields are typically a sign of investor anxiety, “a flight to quality,” and importantly would argue against a continuation of the ongoing stock rally. Bond investors apparently lack confidence in the Trump reflation trade. Further, falling yields would not be expected in a period of tightening or more restrictive monetary policy as is currently the case with another quarter point hike in the Fed funds rate expected in June.

Similarly, the dollar has been weak with the dollar index falling (weakening relative to a basket of other currencies) by over 4% from an early March high of 101.5 to 97. Economists would expect the dollar to rise when U.S. monetary policy is restrictive (the Fed is raising rates) and most other central banks remain accommodative. Once again, dollar weakness would argue against additional Fed rate hikes, a strong economy and thus the stock market rally. Stocks and bonds are giving very mixed signals.

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