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EUROPE'S LOST DECADE AND ITS BANKS

WHITE PAPER

Europe's Lost Decade and its Banks

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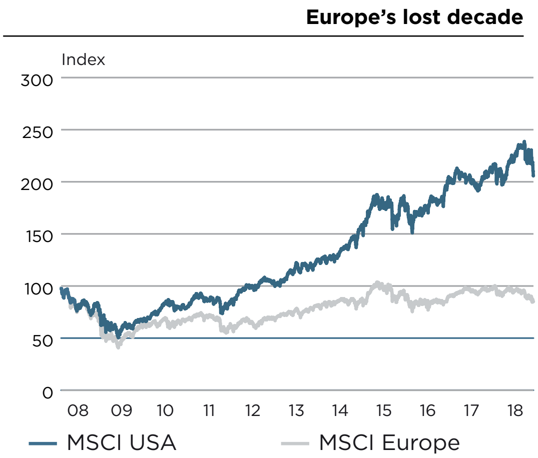
Excecutive summary

The underperformance of European equities over the last decade has been massive. We believe this is attributable to both the composition of equity markets with Europe having a deficiency in large cap growth companies as well as the severe underperformance of its banks. European banks have underperformed because of strict regulatory peassures, the introduction of extreme monetary policies in order to defend the Euro as well as demographic aging reducing loan demand and thus the earnings power of banks. We see few, if any, reasons why this will change in the forseeable future, and continue to focus our attention in Europe on the continents high quality global brand owners that are true compounders.

The underperformance of European equities over the last decade has been staggering. Occasionally strategists and other financial commentators have called for this performance to reverse, but time has shown that such recommendations are difficult to get right, to say the least. To date, reversion to the mean has been elusive. European equties are still trading lower than before the Great Financial Crisis (GFC). Since markets peaked in 2007 MSCI Europe has fallen approx. 10% while MSCI US has increased 128% – showed in figure 1 below. Over this period Europe has only had few short periods of outperformance. It certainly has been a lost decade for the average investor in European large cap equities.

Figure 1



Source: Bloomberg as of Dec. 2018

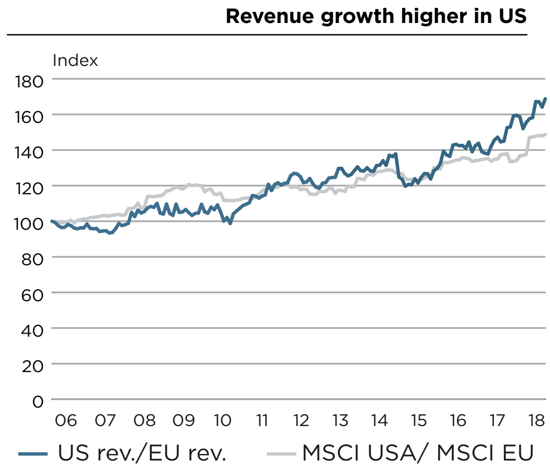
We believe the drivers of the lost decade in European Equities are low revenue growth and Europe's troubled banks.

Revenue growth has been the driver of relative performance

It sounds too simple to be true – but simply buying high revenue growth over low revenue growth has generated outperformance over the last 10 years.

Figure 2 below shows that the relative performance of US equities vs European equities is almost entirely determined by relative revenue growth (US trailing 12mo revs divided by European). If the US grows its revenues faster than Europe, it outperforms. The correlation is 94%.

Figure 2

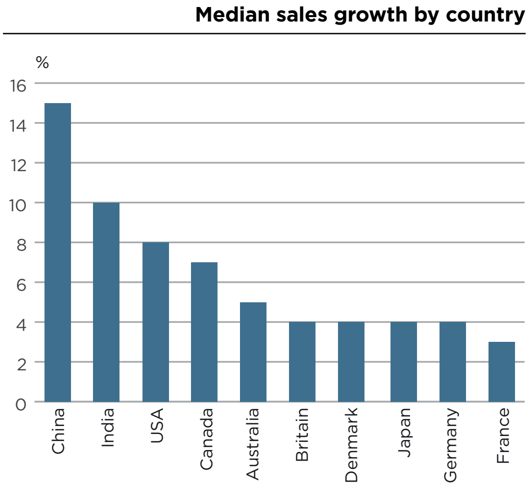


Source: Bloomberg as of Dec. 2018

If revenue growth is the key driver of relative performance, the US and certain Emerging Markets remain good bets. Figure 3 on the next page shows median sales growth by country. The US is at 8%. Most European countries are significantly lower.

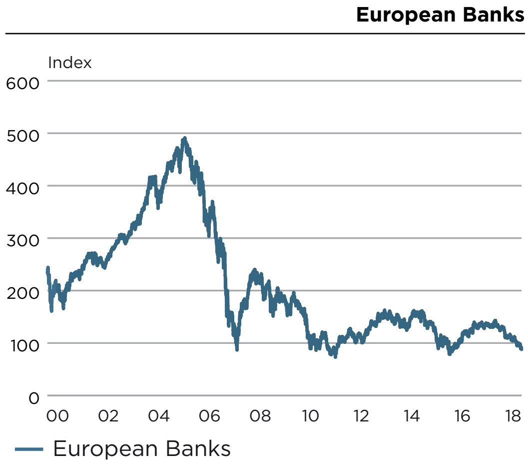
> **To date reversion to the mean has been elusive.**

Figure 3



Source: Baird as of Dec. 2018, 12 mth. historical (end Nov. 18)

Figure 4



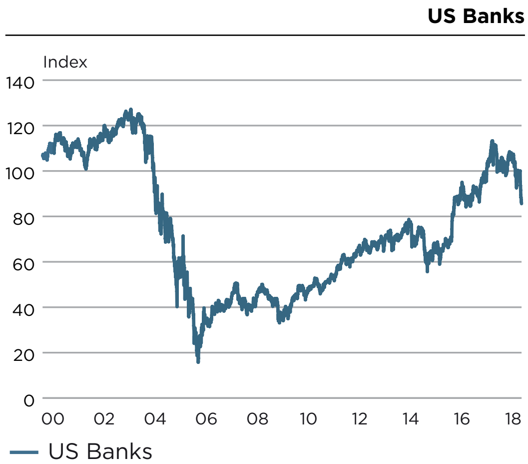
Source: Bloomberg as of Dec. 2018

Why is this relationship so strong? Simply because for long-term share price appreciation the most important driver is earnings (or more specifically cash flow) growth, which is impossible to generate on a long-term basis without good revenue growth. European companies are generally exposed to slower growing end-markets than the average US company, and therefore on average they underperform in the longterm.

Banks have been drivers of underperformance in Europe

At a sectorial level, the most important reason for Europe's underperformance is clearly the significant under-performance of banks in Europe. As showed in the next two figures, the Eurozone banks have fallen 80% since the peak before the GFC and are barely higher today than where they traded at the bottom of the Great Financial Crisis in 2009. Conversely, US banks are "only" down 30% over the same period, but still up 70% from the bottom in 2009.

Figure 5



Source: Bloomberg as of Dec. 2018

The main reason for this difference in performance is that the US managed to fix its banking system early on with the TARP program in 2009, while fixing European banks was left unresolved for many years. This was because the complexities of a troubled monetary union in Europe continuously pushed out addressing the real issues of hidden losses on systemic important banks' balance sheets across the Eurozone.

The historic underperformance of banks over the last decade is clearly attributable to both very weak Return on Assets (RoA) and declining leverage, the amount of loans relative to equity capital. The weak RoAs have been largely driven by elevated loan losses, while the declining leverage from around 30 times total assets to equity to 18 times today has been driven by regulators forcing banks to strengthen their balance sheets by issuing more equity capital.

Structural impediments for European banks

Despite European banks being very oversold today, we see at least two structural reasons for continued skepticism when it comes to a fundamental turn around in the earnings power of European banks.

Ill constructed monetary union

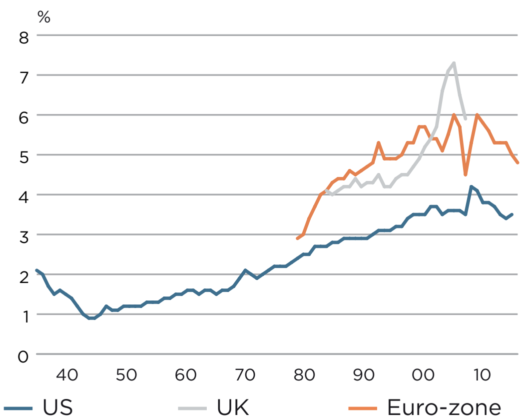
To state the obvious, European banks are the casualties of an ill constructed monetary union (as well as their own follies). In order to defend the common currency, the European Central Bank has followed a policy of extremely low or even negative interest rates as well as quantitative easing (QE), which has reduced net interest margins and therefore the profitability of the banks. Before (if ever) the Euro project is sufficiently strengthened via the addition of a fiscal union, it is highly unlikely that European banks will be able to increase their earnings base in any significant way and to contribute positively to the long term performance of equities in Europe.

Demographic headwinds

Another fundamental problem for Europe is demographics. It is very likely that the GFC coincided with a seismic shift in the composition of our populations. In many ways Europe is beginning to look like Japan, with a time lag of perhaps 15 years – which means that Europe is in the midst of a Japanese Crisis today. An ageing society is a society that consumes less and demands less credit compared to younger societies. We have most likely come to the end of a 60-70 year credit expansion and are now in what has been termed a "balance sheet recession", where no matter how low interest rates go, the private sector refuses to take on more credit until people have reduced indebtedness to acceptable levels for themselves. This is bad news for the banking sector, since revenues will take a double hit both from net interest margin compression because of structurally low interest rates as well as from weak loan growth. This will be a complete reversal of the last 60-70 years' development, as shown in the chart below. Banking revenues have been growing as a share of the economy since WW2, and we are (also with the active help of politicians) now in the process of downsizing the banking sector to a much-reduced share of the economy. How long this will take no one knows, but the secular shift is ongoing.

Figure 6

Banks revenue as percent of GDP



Source: Berenberg Bank as of Dec. 2018

Decomposing the last decade's equity returns

The contribution of banks to the underperformance of European equities is confirmed by looking at individual stocks' performance over this more than 11-year period. As can be seen in figure 7 – 7 out of the 10 worst stocks in Europe were financials. In the US, it was 6 out of 10. But in order to judge the future performance it might be interesting to look at the characteristics of the companies which have outperformed over this period.

Figure 7

Best and worst stocks' contribution to index return

Europe	Contribution to Return	USA	Contribution to Return
Oct. 31 2007 to Nov. 30 2018		**Oct. 31 2007 to Nov. 30 2018**	
10 Best Stocks		**10 Best Stocks**	
Nestle S.A.	2,7	Apple Inc.	12,1
Roche Holding Ltd.	1,4	Amazon.com, Inc.	4,9
Novo Nordisk A/S Class B	1,3	Microsoft Corporation	3,4
Anheuser-Busch InBev SA/NV	1,3	Alphabet Inc. Class A	2,9
Novartis AG	1,1	Home Depot, Inc.	2,7
AstraZeneca PLC	1,1	Visa Inc. Class A	2,3
British American Tobacco p.l.c.	1,0	Johnson & Johnson	2,2
SAP SE	1,0	JP Morgan Chase & Co.	2,2
Diageo plc	0,9	Philip Morris International Inc.	2,2
ASML Holding NV	0,9	Oracle	1,9
10 Worst Stocks		**10 Worst Stocks**	
Societe Generale S.A. Class A	-1,0	Exelon Corporation	-0,7
UBS AG	-1,0	ConocoPhilips	-0,7
Deutsche Bank AG	-1,0	HP Inc.	-1,0
ArcelorMittal SA	-1,0	Federal National Mortgage Assn.	-1,1
Lloyds Banking Group plc	-1,1	Merrill Lynch & Co. Inc.	-1,5
HBOS Plc	-1,1	Wachovia Corp.	-1,5
UniCredit S. p. A.	-1,7	American International Group, Inc.	-2,6
E. ON SE	-2,0	Bank of America Corp.	-3,6
Nokia Oyj	-2,1	General Electric Company	-4,8
Royal Bank of Scotland Group plc	-2,4	Citigroup Inc.	-4,8

Source: C WorldWide as of Nov. 2018

The outperformers in Europe have been stable growth companies in household products (4 companies), pharmaceutical companies (4 companies) as well as 2 technology companies. In the US the outperforming companies were technology (6 companies) but also companies exposed to the US domestic economy like JP Morgan and Home Depot. All outperforming European companies were multinationals operating in global markets, the insight being that Europe in itself is not capable of generating any significant demand but is a cyclical derivative of the world economy. Companies exposed to the European economy have generally not done well, while the US economy is capable of generating domestic demand to drive outperformance in stock markets. Furthermore, US outperforming companies tends to be much younger than similar European companies. 7 of the 10 outperforming European companies have been around for more than 100 years, while in the US it is only 3 companies. Half of the outperforming companies in the US, Apple, Home Depot, Alphabet, Amazon and Microsoft are only 20-40 years old. Younger companies tend to be more dynamic, have higher growth rates as well as having larger total addressable markets, somehow also explaining why the outperformance of US companies has been much stronger than the outperformance of the European stars.

Lessons from History

Given the uncertainties about the European economy due to demographics and potential fragmentation of the monetary union we believe it is prudent to avoid companies dependent upon European domestic demand and to focus attention in Europe on the continent's high-quality global brand owners that are true compounders. These companies will continue to be critical components of our Stable Growth allocation in portfolios.

> **Investors are being rewarded for investing in companies with sustainable high revenue growth.**

Being totally dependent on European domestic demand one should generally avoid investing in European banks. Banks have very little, if any, pricing power and tend to be extremely cyclical, and therefore are not candidates to be owned over the business cycle, but only "rented" for brief periods – if you can get the timing right. Furthermore, the GFC radically changed the demand for credit at a time when demographics is adding downward pressure on demand for banking services. This in contrast to Emerging Market banks, where there are secular growth opportunities in many markets.

The old continent truly is an old continent. New company formation and creative destruction is very low due to demographics and extremely low interest rates. In a world with generally low inflation and interest rates due to technological acceleration, demographics, etc., investors are being rewarded for investing in companies with high sustainable revenue growth. Investing in companies which sustainably outgrow the average company has been a viable strategy for out-performance and will continue to be our focus for the future.


IT IS NOT ONLY
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