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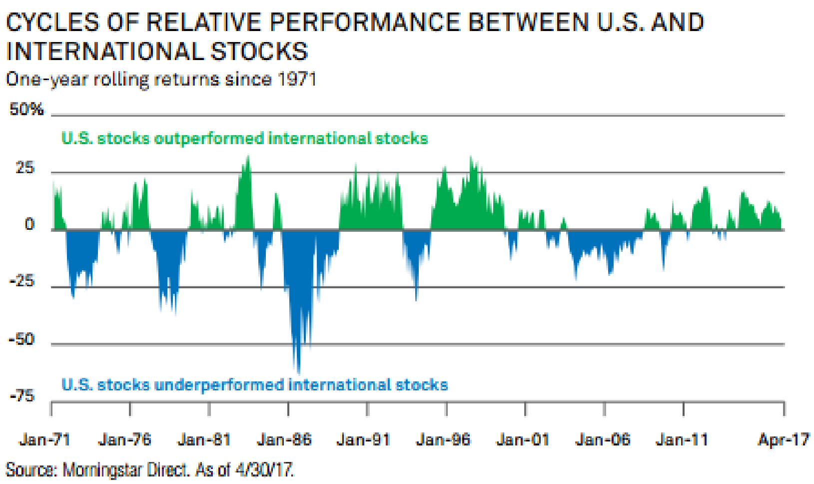
Our Tactical Call: Europe Inc.

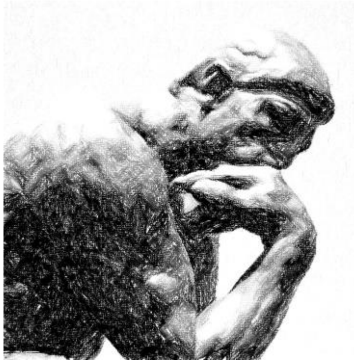
Since the end of the 2008 financial crisis, the S&P 500 has outperformed the MSCI EAFE by 59% and the Euro Stoxx 600 by 49%, making the U.S. the ultimate destination for global investors seeking solid, less risky assets in a politically uncertain world.

However, history shows that relative performance between U.S. and international markets is cyclical, and over the past year the performance of international stocks has strengthened relative to U.S. This turning point in market leadership is being driven by several factors overseas, including lower valuations, aggressive monetary accommodation and improving economies. It also reflects the fact that after producing stellar, double-digit returns for much of the past 5 years, U.S. equities have started to become a crowded trade.



After delivering less than half the total return of U.S. equities over the past eight years, European stocks are starting to gain traction. The Stoxx Europe 600 Index is up more than 15% this year, by contrast, the S&P 500 Index has gained around 5.7% over the same period (see graph below).

The Thinking Man's Approach



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May 2017 BSP
Series #49

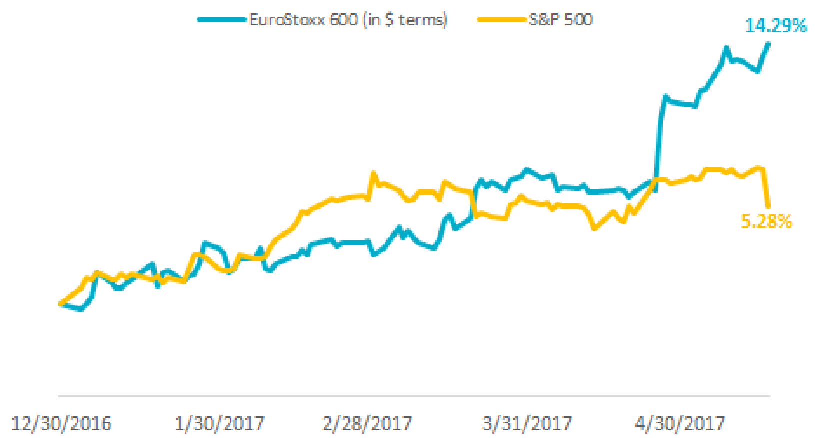
In the eight years since the bull market in stocks began, U.S. shares have persistently outperformed other equity markets. Now, a shift in leadership has taken place and overseas markets have attracted more investment fund flows.

Since mid-2016, European growth has strengthened steadily and is now receiving a boost from a pick-up in global economic momentum.

Valuations, Earnings Growth, accommodative monetary policy, improving labor markets and diminished political uncertainty have all contributed to a reassessment of risk/reward for European Equities.

As a result, we believe Europe may provide an opportunity for investors, as a tactical short-term call within their portfolios, ahead of economic growth and global reflationary trends.

For more on how we are positioning our portfolios, please contact your investment advisor or email: ideas@bigsurpartners.com



Although U.S. stocks are likely to continue moving higher in this "Goldilocks" economy, investors have begun to recognize that the best opportunities no longer lie in the United States.

In this month's Thinking Man, we discuss why we believe Europe offers a compelling opportunity as a short-term tactical call within our client portfolios. Valuations, EPS growth, Monetary Policy Divergence favoring Europe, labor market slack and a "calmer" political landscape for the remainder of the year are some of the reasons behind our view.

Valuations

Over the course of this eight-year bull run, U.S. equities have outperformed European equities by more than double, with the S&P 500 index returning 215% while the Stoxx Europe 600 index returned just 105% in the same span of time.

U.S. fundamentals still look promising and economic growth is decent. Profits are rising and interest rates still remain low. However, the U.S. is now in its eighth year of economic expansion, and diminished slack in the economy should drag on earnings growth going forward. Annual real GDP growth over the next five years is unlikely to average more than 2% and nominal GDP growth is unlikely to exceed 5%. From a historical standpoint, U.S. valuations seem high, trading at 18x.

In contrast, Europe's current forward P/E at 14.9 times is just 2% above its 25-year average. Analysts in Europe, while probably still a little too optimistic in forecasting an 14% 2017 earnings jump, may end up being more accurate than their U.S. counterparts. In addition, the average dividend yield on the MSCI-Europe index is 3.2% compared to 2.0% on the S&P 500 (see table below).

	S&P500	MSCI EAFE
Forward P/E Ratio	18	15
Growth Rate (1 year forward)	10.50%	16.20%
PE/Growth Ratio	17	9
EPS Growth Rate (Actual Q1 2017)	14.60%	23.00%
Dividend Yield	2.00%	3.20%

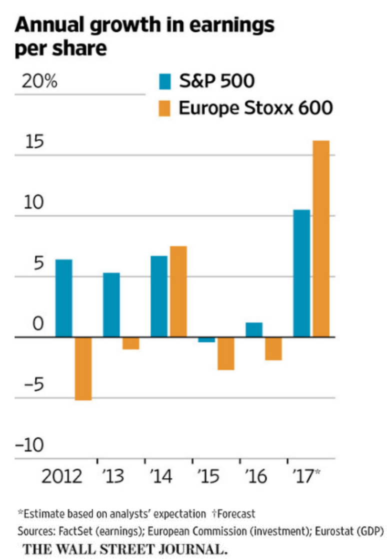
Source: Bloomberg

It is important to note that some of Europe's cheapness is concentrated in Financials (20%) and Energy companies, whereas the main component in the American stock market is derived from Technology firms, Apple, Microsoft, Amazon, Google and Facebook are the S&P's largest components, and they are far from cheap. Overall, the US has outperformed because of its smaller weight in financials (14%) and also because of its faster resolution of bank capital problems, particularly relative to Europe.

Even so, if energy and financials were excluded, Europe would still trade at a more attractive valuation than its American counterparts. And while markets have enjoyed the US's earnings recovery after six quarters of no growth, European stocks have been in an earnings depression for much of this decade. Morgan Stanley forecasts the MSCI Europe Index earnings to gain 16% in 2017.

Earnings Growth

The biggest positive for European equities so far this year has been the turnaround in earnings. On average, companies have boosted first quarter EPS 23% from year-earlier levels, according to estimates from JP Morgan, outpacing the 14% increase from S&P500 firms. This constitutes the strongest quarter in the last 7 years.



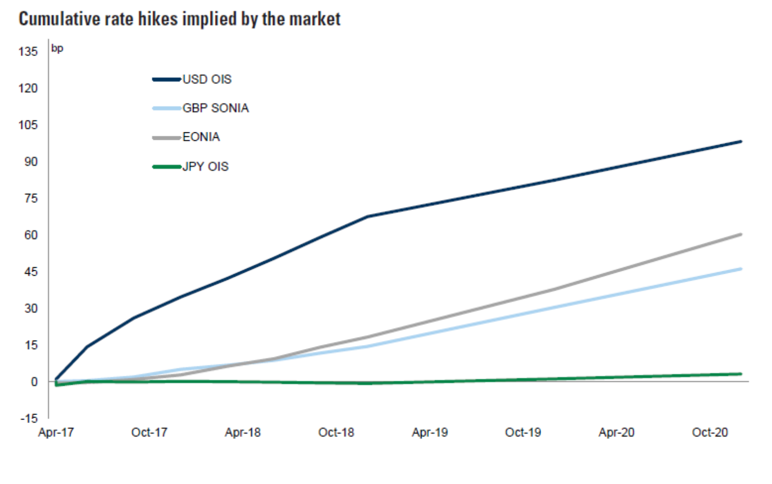
Looking ahead, global growth prospects are beginning to pick up, and economies which are most exposed to global growth tend to benefit. According to Goldman Sachs Investment Research, the U.S. is the least "global" country, with nearly 69% in domestic sales exposure, compared to Europe's 53%, explaining future earnings forecasts for Stoxx Europe 600 companies of 16%, compared to a 10.5% for S&P 500 firms.

The improved earnings performances this time are being delivered by sales increases rather than cost initiatives. Around 50% of European earnings come from outside Europe, therefore the region stands to benefit from a cheaper euro, increasing sales and subsequently, growth in corporate margins. Additionally, increasing consumer spending and capex growth are making inflationary pressures reappear in the system, which trigger pricing power pick up and in turn, help margins.

Divergent Monetary Policy

Much of what markets have experienced after the latest financial crisis can be attributed to Monetary Policy, and its critical role in shaping their speed and direction. The USA has started the QE program sooner than Europe and has done banking restructuring sooner and more aggressively, which has resulted in a large outperformance.

In contrast, economies like Europe and Japan are battling deflation and slack in the labor market, which as a result, call for Quantitative Easing (QE). In the case of Europe, this policy is expected to last at least until the end of this year. Loose monetary policy in Europe is about lowering the currency, and keeping rates low, which will import some inflation to offset deflationary pressures.



Source: Bloomberg, Goldman Sachs Global Investment Research

The Monetary Policy path depicted in the graph above showcases the divergence in the expected path of policy rates. As shown, additional hikes are expected in the next coming years, and divergence will prevail. The market is discounting at least 100bps in cumulative rate hikes for the Fed, which is half of what is forecasted for the European Central Bank, furthering dollar strength against the euro and crimping U.S. exporters while lifting European ones.

Labor Market Conditions

Across the waters, the U.S. is essentially at full employment, with a 4.4% rate, and US profit margins have peaked with limited capacity of expansion. In a tight labor market, many businesses simply don't have the profit margin cushion necessary to raise wages to attract or retain talent. Analysts at Goldman Sachs estimate that for every percentage-point increase in labor-cost inflation, earnings for companies in the S&P will get shaved by 0.8 percentage point.

Despite a clear improvement in many indicators, labor markets in most euro area countries appear to still be subject to a considerable degree of underutilization. The region has an unemployment rate of 8.2%, and labor underutilization, as a measure for labor slack, is still 8% higher than its level during the 2008 crisis. Even if we were to remove Germany from the equation, the figure would still be 7% above pre-crisis levels, resulting in a larger capacity to absorb this slack. Further declines in unemployment could fuel above-trend economic growth for many years to come.

Effect from Policy & Reforms

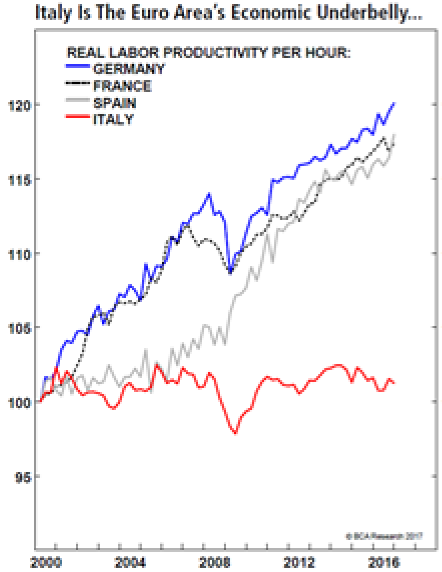
Politics took center stage during most of 2016 and 2017, and the market lingered on concerns around the prospect of an anti-establishment victories in countries like the Netherlands and France, but as events unraveled and election outcomes proved in favor of the Euro Area, many of these concerns dissipated.

The recent victory for Emmanuel Macron, against nationalist Marine Le Pen, offers the bloc a particular chance to hit reset and revamp the Euro. In fact, during 2012 and 2014, Macron was closely involved in Franco-German discussions over how to create deeper economic integration in the core of the Eurozone, and in his first full day in office, made his way for Berlin, where he and Merkel called for a new era in Europe.

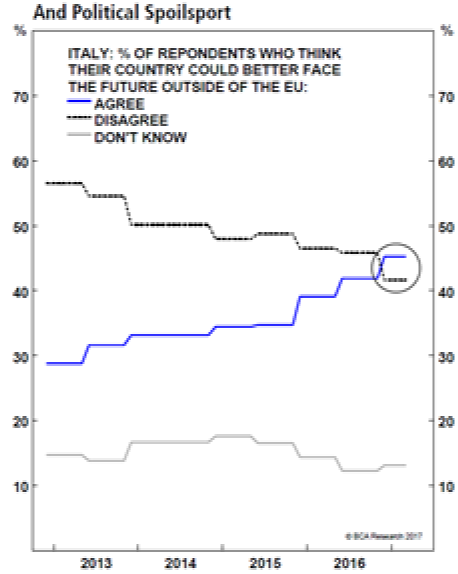
Even his prime minister selection, Edouard Philippe (previously France's ambassador to Germany), reflected the disposition the leader has for cooperation with its closest neighbor. Both have noted the need for a reform in the European Union treaties to deepen its integration and protect it against crises. France and Germany have many common goals as the just-begun, two-year Brexit negotiations kick off, including efforts to convince financial institutions to abandon London in favor of Frankfurt and Paris, and strengthen faith in the euro.

However, the recent victories against the nationalistic pressures in the Euro Area, do not entirely decrease the region's vulnerability; Italy is still economically and politically the Euro's weakest link. Other events such as Brexit, and the upcoming German elections do not really challenge the integrity of the European Union.

Italy Is The Euro Area's Economic Underbelly...



And Political Spoilsport



The rise of Italy's Five Star Movement, with an unclear yet anti-Euro agenda, remains true to its promise to hold a referendum on euro membership, and has had investors on edge for next year.

Italy has fiscal problems, banking sector deficiencies, a refugee crisis, and a lack of rule of law, all of which can be considered ingredients in the perfect crisis recipe. In fact, polls suggest an increasing percentage of Italian voters believe their future is better served being out of the Euro Area (see graphs above). With public discontent on the rise surrounding current economic conditions, statistics show Five Star is the most popular party in Italy, with the support of at least 32% of the electorate, compared with 26% for the PD, the ruling center-left democratic party.

There is still some hope however, that Matteo Renzi, Italy's former prime minister who last year was compelled to resign after losing a referendum on constitutional reform, will return to the helm of the ruling center-right party in his plan to win back the premiership in next year's elections. Mr. Renzi obtained more than 70 per cent of the ballots cast by 2mm party supporters, alleviating concerns that the referendum loss had discredited him.

In the near future, however, there is no real threat to the integrity of the Euro as elections in Italy take place until May 2018.

Conclusion

The United States has significantly outperformed European markets by twice as much since the financial crisis. However, a rotation and change in leadership started to taking place last year, with European equities finally beginning to outperform. We believe this catch-up in returns will likely persist given that fundamentals have significantly improved, political risks have subsided (at least until the Italian elections), and the market's ingredients for growth are more plentiful than in the U.S.

These ingredients include more attractive valuations, earnings growth, improving labor markets, and a favorable monetary policy. Our view at BigSur is that European stocks offer a compelling investment opportunity for portfolios during the next 9-10 months, therefore our tactical recommendation for clients is to reduce their current over-concentration in U.S. equities by gradually adding investments that offer greater exposure to the overall European market.

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