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Europe: Continent of Opportunity for Selective Asset Managers

Craig Blessing
Hi and welcome to another episode of Away from the Noise Thornburg Investment Management's podcast on key investment topics. Economics and market developments of the day. I'm Craig Blessing, Client Portfolio Manager for International Equity at Thornburg. Joining me today is Matt Burdett, managing director and Portfolio Manager for International Equity Strategies. The topic today is Europe. Europe is the single biggest component of international equity markets, making up about 50% of the MSCI, the Developed Markets Index, and about a third of the MSCI ACWI Ex-USA Index, which includes the emerging markets over the last couple of years.

Europe has also become the market U.S. investors most love to worry about, along with China. That worry has been reflected in returns, with Europe down 23% year to date versus 19% for the S&P 500 and with European companies now trading at a 33% valuation discount to the S&P the widest discount of the recent 15-year period where the U.S. has outperformed international.

In recent weeks, though, we've seen a nice bounce in Europe even a bit stronger than the recent bounce in the U.S. Matt, I understand from our conversations that you've become a lot more constructive on Europe and think it's time for investors to begin allocating their what?

Matt Burdett
I do think it's an interesting time if we just rewind a bit to the beginning of the year. You know, look, I think a lot of people were pretty optimistic on Europe and just kind of the earnings profile there. Obviously, that was completely disrupted by the Russia-Ukraine situation and many investors just categorized Europe as to one single entity and all the companies in it.

And so, Europe sold off pretty much uniformly I think, in a very indiscriminate way. It was just a lot of uncertainty. And the main financial implication of the Ukraine war has really been the impact on energy and energy prices, because Europe was getting so much of its gas, it depends on what country, but somewhere in the high thirties to low forties percent of their supply from Russia, there became an obvious risk of supply of natural gas to Europe and in Germany in particular.

So, gas prices rose to multiples of what the price had been on average the prior year. And this created a lot of uncertainty around earnings being crimped by higher costs, households being crimped by higher energy bills. And so, a lot of uncertainty around that. So, what happened was the European governments ordered all of their gas companies to fill storage, gas storage ahead of this winter.

Right. They were told to fill gas storage at really at any price. So, a price agnostic buyer. And what that did was it brought in speculators, in our opinion, that drove the price up much higher

than fundamental value would indicate. Since that's happened the last few weeks, these prices have rolled over pretty meaningfully. Just some stats in Europe.

The ETF, gas price which is similar to a Henry Hub price in the U.S. This is kind of the price that you would look at to see how much gas costs in a futures market the day ahead. ETF price is down over 90% from its peak. It went to a peak of almost €350 per megawatt hour. And it's now at 28 €50 per megawatt hour.

And then if you look at the month ahead TFA gas price that is down about 65% from just over €300 per megawatt hour to about a little over €100 per megawatt hour. These prices are still much higher than the average prior to the invasion, but they're down meaningfully. And the reason why is because as storage was filling, these prices started, started coming down.

When you think about looking at storage now, when the invasion first happened, there was a fear of Europe would not get through the winter. Well, gas storage levels now across Europe are currently at 94%. And in Germany, which was the most exposed country there at close to 98% for their benefiting from a little bit warmer start to winter that helps a lot but also there's just a really strong effort to fill the storage now there was an obvious cost to that as I explained in the higher prices but now that these prices have come down you kind of feel like the crisis scenario is somewhat contained.

And according to Bloomberg, any if in most weather scenarios for this winter this storage would suffice to get Europe through the winter next winter. 2324 is a different situation. But I think Europe is kind of proven to be better prepared for this, or at least in this scenario with respect to gas. So, you have that improving situation.

Then you also have, as you highlighted, the valuation differential. So, the MSCI Europe Index is roughly 11 times 2023 expected earnings versus the MSCI U.S. about 16 times 2023 earnings. So, it's a meaningful discount and those some discount, you know, is merited given the crisis is not resolved. But these are pretty good starting points. And I think what's driven investors to Europe a little bit recently is the fact that the gas situation, at least in the short term, seems more contained.

Craig Blessing
The ECB raised interest rates by 75 basis points recently and we know that the Fed has raised rates by 300 basis points so far. This year with presumably more to come. Where do you see the two regions in their respective monetary, fiscal and inflationary cycles, and how does that impact markets going forward?

Matt Burdett
Yeah, look, I think that's a critical question. I think the path of Fed policy has actually been the most important financial market determinant, even more so than the Russia-Ukraine war. I think

when the war first broke out, that was the focal point for everyone because no one knew how quickly it would end or would it spread to other regions.

And so, the path of fed hiking has been the really the main focus of markets. But the Fed was very much behind the curve, first ignoring inflation and then deeming it to be transitory. And now here we are with the Fed aggressively hiking. And, you know, this is the most aggressive Fed hiking cycle I think we've seen in many decades.

So that really impacted a lot of financial asset prices. Now, Europe is just starting to catch up. They're not quite there. They started this year with a -50-basis point deposit rate. They've raised rates, monster increases, in rates recently and now up to close to 200 basis points positive, which is a big change after many, many years of negative rates.

And all of this is to combat inflation. And the key thing to think about for the two regions is the composition of inflation in the U.S. versus that in Europe. Is the U.S. version is what I would call a stickier version or one that is more secular in nature potentially versus Europe about two thirds roughly is commodity driven and commodity driven.

Inflation can generally be tamed once supply and demand balances in those commodities comes back to balance. And so, if you were to look at, you know, comparisons of inflation, that's the big difference. So, for the U.S., everyone's waiting for the Fed to pivot in terms of how fast it will continue hiking. Will there be a pivot to slow down?

You know, we'll have to see will all depend on the path of inflation. But as I said, the U.S. inflation mix is a stickier mix. And so therefore, it kind of can create a little bit more uncertainty with in terms of the timing of when it gets to target versus what could happen in Europe, which is a more cyclical driven inflation.

Craig Blessing
There seems to have been a surge of populism in Europe recently. With Georgia Malone becoming prime minister of Italy, the far right, doing well in French elections and even a right-wing bloc winning a small majority in Swedish elections. How do you see that developing and how do you think it influences markets?

Matt Burdett
It's a very important aspect of the world now. It all started with Brexit then went to Trump's win here in the U.S. Let's just take the Italy case because that's probably the most important one, I think, with respect to how European financial assets and stocks in particular will perform. Maloney's party is a far right party, but I think so far she has actually been very balanced in her comments you know, there was fear that that the party would be anti-EU and not so supportive of Ukraine.

And she's come out and been very vocal that that's not the case very much still wants Italy to be a part of the European Union and has voiced support that the West has provided to Ukraine. So I feel like that risk was probably exaggerated a little bit. I think ultimately the reason for this is that Italy receives or is eligible to receive a decent amount of recovery funds from the COVID pandemic funding scheme that was created in Europe.

If they don't adhere to the rules, they're not going to get the funding. So that's kind of an important driver to influence behavior. I think we'll always have to worry about, you know, populism and what happens. But in the case of Italy, at least, the discounted valuations in the Beatport bond spread kind of reflects that there's still some risk there, even though so far at least, the tone from the new government has been much less harsh than I think people people would have thought.

So, I think we just have to find a balance and assess as we get more information.

Craig Blessing
The strength of the U.S. dollar has been a big part of the negative return story for U.S. investors in Europe this year with the MSCI Europe Index down 15% year to date in euros, but 26% in dollars, the dollar is at levels we haven't seen since 2000 thousand 22. Around the last time. There was an inflection point in the performance of international versus the U.S.

Do you think that the dollar could be a part of the potential upside story you've been telling about Europe?

Matt Burdett
Yeah, I do. It's pretty amazing how much the dollar has moved. I mean, to your point, it hasn't been at this level for 20 years. So, when you're investing internationally, what has been a headwind of strong dollar can revert to a tailwind. So, what conditions would need to happen, you know, for that to play out, I guess is the real question. Because of the aggressive path of the Fed, the dollar has been strengthening around that aggressiveness. And a lot of times, at least in my experience, currency moves can get very crowded. That can be a very you know, as we say, everyone's in the same side of the boat. And when the boat starts to tip over, everyone runs to the other side.

So just as quickly as the dollar strengthened, it can reverse pretty quickly, too. You know, look, I think the Fed is a lot closer to its peak Fed funds rate than it was at the beginning of the year. So, I think you have to think about it in terms of relative change, right? What's the relative change in the Fed funds rate now and what does that mean for dollar direction, you know, going forward?

The other side of the coin is what's happening economically in this case, Europe, as mentioned earlier, you know, the energy crisis seems to be somewhat contained, at least in the near term. It doesn't mean it's totally solved, but it's somewhat contained in the near term. And so that at least

provide some green shoots for better economic activity or at least not as severe as people were probably expecting.

And therefore, you could have not only the euro, but other major currencies gaining a little bit more support, which, you know, if you're a dollar-based investor, the stock doesn't have to move at all for you to make money. So we're probably closer to the dollar turning the other direction than we are the dollar continuing to move materially higher from here.

Craig Blessing
Europe is probably the most ESG of global regions and the most advanced in the energy transition at times. To me, that feels like a huge investment opportunity, and at times it's felt like part of Europe's problem. What do you think? Do you have any thoughts.

Matt Burdett
That's a great question. I think it is both an opportunity and a problem. I guess, you know, an opportunity in the sense that Europe had a chance to really take a leadership role in the world in terms of how it approached ESG policies, and in particular on the energy front and the climate front. The flip side to it is that I don't want to say single minded focus, but let's just say that very centralized focus on climate and clean energy.

You know, really kind of meant that they took their eye off the ball in terms of understanding the realistic path to getting to a pure green energy system, which resulted in lack of investment in traditional energy sources. And in fact, the shutting down of traditional energy sources mainly because they thought Russian gas would always be there. And now that it's not, it's become somewhat of a challenge. I would say it's about as rude a wakeup call as you're going to get from a policy standpoint. But they'll get through this, right? They're going to get through this. They're making some reversal, of course, with some traditional energy sources, including coal power, which they have the ability to do. And I think the fact that they're doing it is showing that, look, they have to be sensible in terms of what they're doing over there.

So it doesn't mean they can't continue to lead. I think it just means there's a little more reality put into the thinking.

Craig Blessing
I know that we have a number of European companies that would be considered ESG leaders in our portfolio. And broadly, those companies have cheapened by about 350 basis points versus the broad index this year. Do you think that constitutes an opportunity?

Matt Burdett
I think it depends on the company. I wouldn't characterize them in a blanket way. I think in a market like this, there's a lot of opportunity out there because prices have come in so much and valuations are a lot lower than they were. You know, I really think it boils down to what's the

fundamental outlook and is the attractiveness as it relates to the ESG element still there for these companies?

Given the situation has changed somewhat?

Craig Blessing
European companies are among the most global in developed markets, with about 65% of their revenues and about 55% of their costs coming from outside Europe. So what does it mean to be a European company these days? And how do you look at companies that are more global versus companies that are more local now?

Matt Burdett
That's a good it's a good question. I mean, Europe does have a lot of companies, as you highlighted, multinationals global companies, we call them, you know, they just happen to be domiciled in Europe. Right? But they have businesses that are all across the world. And when we analyze those companies versus local companies, we're kind of analyzing the same things.

What's different with a global company versus a local company is just the diversity of, you know, markets for a global company where maybe one region is doing not as great as some other regions. So there's an offset there is somewhat of a counterbalance with the global companies are not as concentrated into one region versus the local companies. You know, obviously, what happens on the ground there in there and their home market matters for the financial performance of the business.

So, in that case, you're really just trying to make sense of what are the drivers around the earnings and the cash flow of that business and what particular risks exist in that. Let's say it's a country specific business that might impact the earnings power and therefore you have to adjust how much you're willing to pay for it and just make sure that you have some downside protection and your entry price.

So, it's really I think you do the same thing for global companies. You just have to think about it in a sense of concentrated risk in a company that doesn't have a, you know, a global business.

Craig Blessing
So let's finish by coming back to the return opportunity in Europe. And as you look across the market, where are you seeing the most interesting opportunities now? And how long do you think it might take for those to materialize?

Matt Burdett
You know, I guess we'd categorize it into like several buckets. The first one we kind of just touched on in terms of the global companies, again, you know, you haven't you have an opportunity to take advantage of lower valuations, just given the pessimism to buy companies that are global in nature. And many of these European companies are global leaders so that's one

area you can look. Another area you could look would be the obvious beneficiaries of this situation, right? And the most obvious one would be energy companies. And Europe has several large global energy companies that are actually very well positioned in their financial results that have come through this year, highlight the power of those businesses, you know, in a situation like this. And look, the end of the day, they're a solution to this problem, I think prior to the crisis, many thought they were part of the problem, but it turns out we actually need them.

And then the last the last area would be to look for those companies that have been somewhat victims of this particular situation and therefore their earnings are going to be more depressed than they have. What we would refer to as kind of a bounce back potential. And we would caution people to want to jump in immediately on those, but put them on the watch, the stock watch list to just be familiar with the business in the model, because eventually things will resolve in Europe and there will be there'll be a bounce back in earnings.

So, there are several things that people could look at.

Craig Blessing
Thanks, Matt, for your expertise and your perspective. And I want to thank all of you for listening today. You can find this and other episodes of Away from the Noise at Thornburg dot com slash insights, as well as on Apple Podcasts, Spotify or wherever you prefer to listen to podcasts. Please rate subscribe and review us. Thank you all again and have a great day.

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