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Is the European Recovery For Real?

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One of the legends in the investment business (Byron Wien, long time chief strategist at Morgan Stanley, now at Blackstone, and a former mentor of mine) once described Europe as "a vast open-air museum". Beyond its unique history and architecture, I believe he was referring to the continent's antiquated labor rules, sclerotic decision-making processes, and socialist-leaning welfare policies to highlight its perennial challenges to economic growth. Indeed, a dollar invested in the Euro Stoxx 600 Index on March 1, 2009 (the start of the bull market) was worth $2.94 while the same dollar invested in the S&P 500 was worth $3.93 as of June 2017. European corporate earnings have only recently exceeded their 2009 levels.

Analysts anticipating a rebound in European stock markets for the last few years have been disappointed as early-year optimism faded by year-end. The European Central Bank's aggressive monetary stimulus efforts failed to bring about the same lift in asset prices that US investors enjoyed. But now, in 2017, European stocks are handily outperforming the S&P 500 for the first time since 2012. Bullish investors point to the valuation discount of European stocks relative to the US and improving economic fundamentals as reasons for the rally to continue. But is it really sustainable?

The economic outlook in Europe is clearly improving. Recent quarterly GDP results exceeded expectations in both France and Spain, and Euro-area economic sentiment rose to a decade-high in July. Earnings of European companies rose 14% in the second quarter versus the prior year, and 54% of company reports exceeded expectations. Manufacturing surveys are rising and Eurozone credit demand has been growing steadily. ECB President Mario Draghi sounded quite upbeat at a recent meeting, telegraphing the ECB's intention to begin to unwind the quantitative easing efforts they began three years ago. And currency markets have taken note, as the euro has rallied more than 13% vs. the US dollar since December.

At the same time, European inflation remains stubbornly low, reflecting continued slack in parts of the economy. The strong euro has some analysts concerned about the competitiveness of European company exports. Persistent high unemployment in Southern Europe, ongoing economic weakness in Italy and Greece, and widespread discontent with the political leadership remain obstacles to continued improvement.

But perhaps the biggest unknown is the looming threat from Brexit, the plan for the United Kingdom to exit the European Union. With fewer than 20 months before the UK officially leaves the EU, talks between the sides are stalled over the size of the exit bill and who pays. In any case, the impact on trade between the UK and EU is likely to be significant and the economic consequences difficult to estimate at this point.

At Ballentine Partners, we have maintained an "underweight" position to non-US developed market stocks, believing that the US would generate better economic performance coming out of the Great Recession. That has been the right call. Nonetheless, our global equity portfolios have averaged 25-30% in non-US developed stocks over that period, a significant allocation. (Our equity benchmark has about 36% in non-US developed market stocks).

While structural impediments may continue to prevent the European economies from achieving long-term growth rates as fast as the US or emerging markets, we believe Europe is enjoying a cyclical recovery that could last for several more years. Unless Brexit derails this momentum, we believe the European recovery could still be in its early stages.

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Bruce is a Managing Director and Director of Portfolio Research at the firm. Bruce rejoined Ballentine Partners in June 2016 after more than 5 years as Chief Investment Officer of City National Rochdale, LLC, in Los Angeles. City National Rochdale, a wholly owned subsidiary of City National Bank, serves family clients across the United States with a staff of nearly 100 investment professionals. Before moving to Los Angeles, Bruce served as Chief Investment Officer of Ballentine in our Waltham office for three years. Prior to that, Bruce spent four years with Morgan Stanley Private Wealth Management in New York and eight years with Glenmede in Philadelphia as Chief Investment Officer and Portfolio Manager. In addition to working directly with a number of family clients, Bruce serves on Ballentine's Investment Management Committee, which is responsible for the oversight of all of the investment activities for the firm. Bruce received an MBA with a concentration in Applied Economics from George Washington University and a BS degree in Business Administration from Penn State University. Bruce holds the Chartered Financial Analyst (CFA) and the Certified Private Wealth Advisor (CPWA®) designations. He lives with his wife in Palm Beach Gardens, Florida.

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