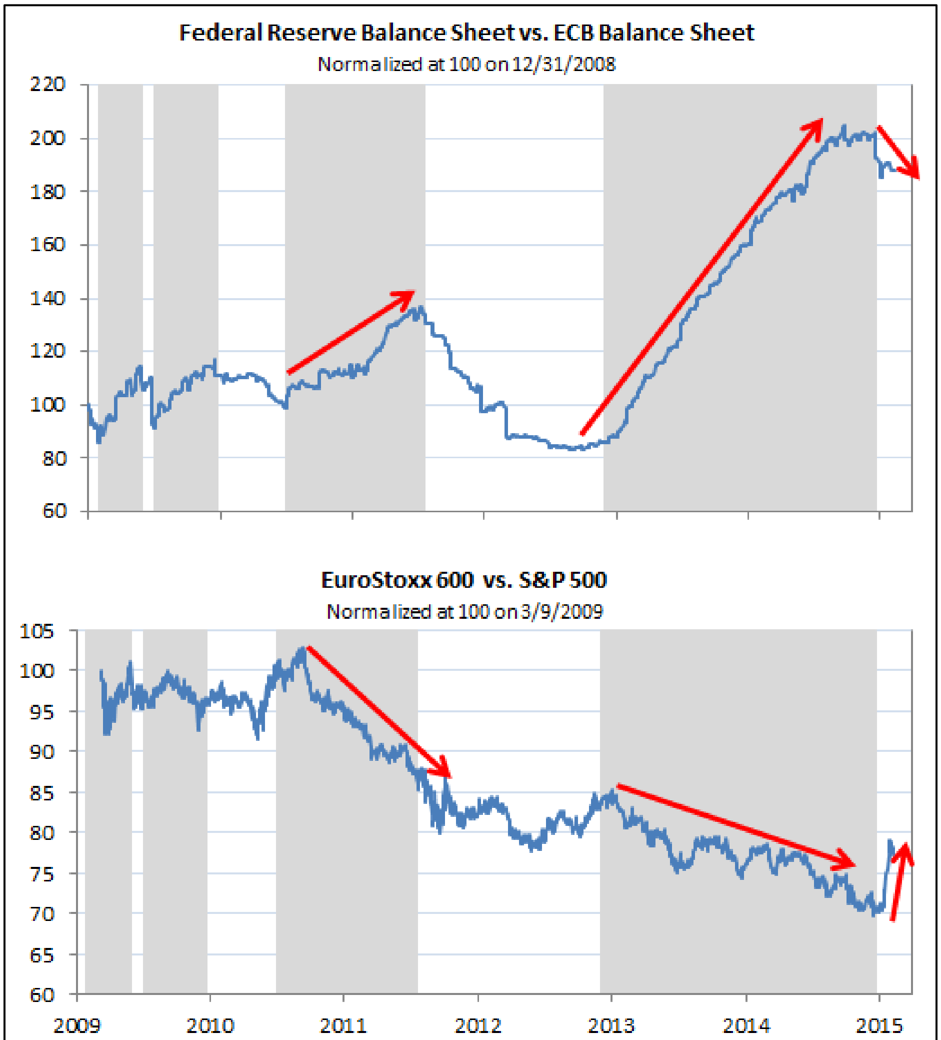
Why Europe… Why Now?

We think it's time… time to be more constructive on Europe. When most people think of the continent, it is usually with the thought of the many headwinds facing them, which include:

- Greece vs. Germany in an austerity tug of war.
- Russia becoming more proactive in the Ukraine.
- An economy that feels like being in another recession.
- Potential for challenges to the European Union from Italy, Spain, Portugal and/or France.

These are all challenges, they are all significant problems and most importantly… they are recognized and being dealt with. More importantly, we are seeing the early signs that European market sentiment is stronger and the outlook is improving. We say this for several reasons, including:

- They instituted a Quantitative Easing program, like the one that turned the US economy around.
- Structurally lower oil prices and a cheaper Euro help this region.
- More pro-growth policies are likely.
- Valuation and sentiment measures point to an unrecognized opportunity for recovery.



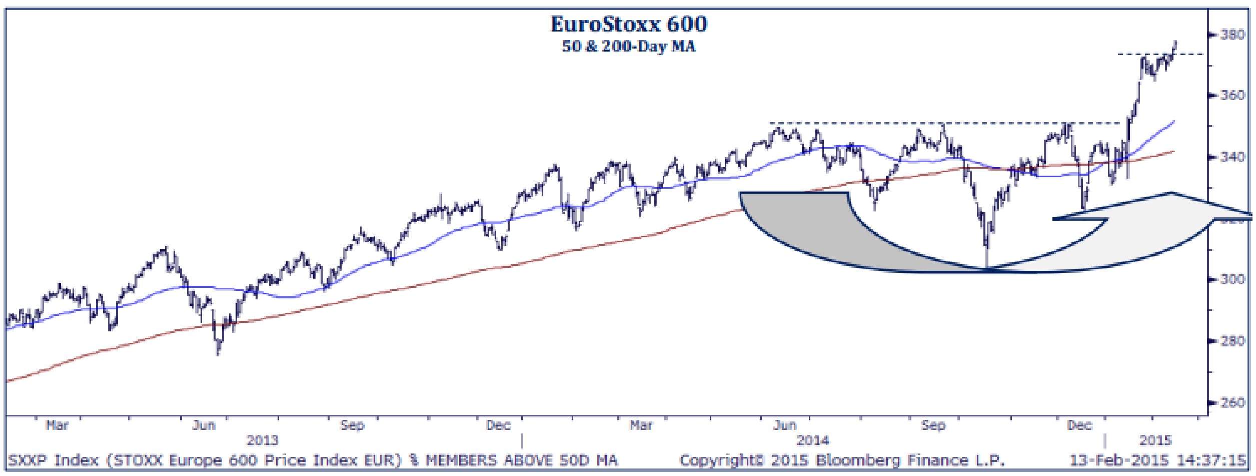
Source: Bloomberg and Todd Asset Management. Shaded areas represent periods when the US Fed balance sheet was expanding greater than the ECB balance sheet.

Quantitative Easing has been a driver of performance differentials between the S&P 500 and EuroStoxx 600 indices (chart right).

Since the market bottom in March 2009, European equity markets have significantly underperformed the S&P 500. While it is easy to point to the sovereign crises to explain this underperformance, we'd argue that it is the response to these crises, or lack thereof, that is to blame. The top chart shows the size of the Federal Reserve and ECB balance sheets relative to one another. When the line is rising, the Fed balance sheet is growing faster than the ECB balance sheet, and visa-versa. The shaded areas in the chart highlight periods when the Fed was easing more than the ECB.

The bottom chart on page 1 (EuroStoxx 600 vs. S&P 500) shows the relative performance of European vs. US stocks. As you can see, European equity markets underperformed during periods when the ECB was being "out-eased" by the Fed. In fact, over 90% of the underperformance since 2009 occurred during periods when the Fed was easing more than the ECB. Mario Draghi's recent announcement that the ECB will expand its balance sheet by more than €1.1 trillion through late 2016, paired with the end of US QE in October 2014, should put an end to this trend. The recent outperformance of European equities could last for years.

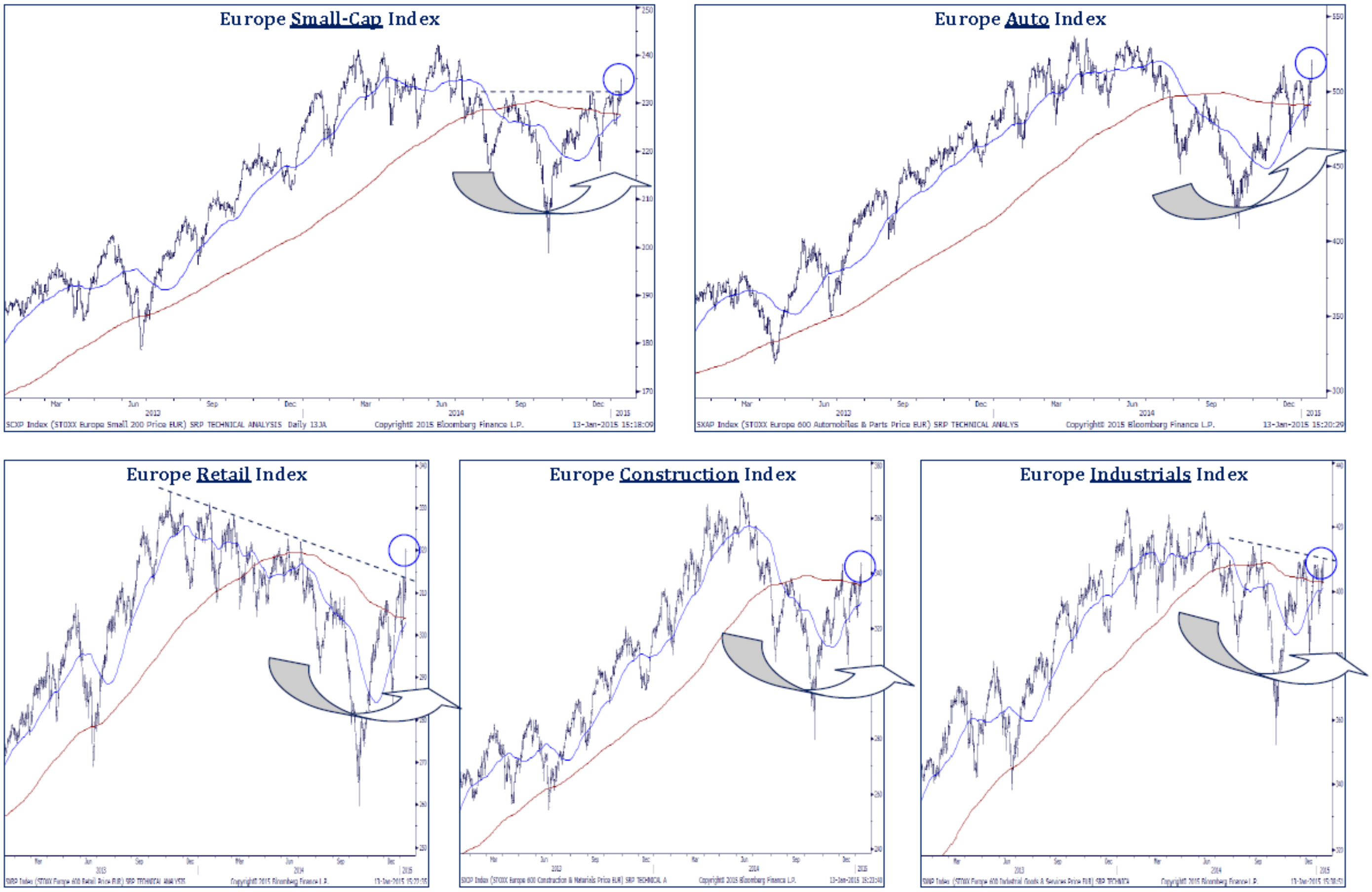
Looking at the chart of the EuroStoxx 600 index (below), we are impressed with how well it has recovered after the troubles of the peripheral nations. With Europe expected to see better economic growth in 2015, we believe the recent breakout in that index is probably a precursor to moving sustainably above the old 2007 and 2000 highs (which were about 10% higher than current levels) similar to the US breakout in 2013. That would put Europe in a secular bull market.



Source: Strategas

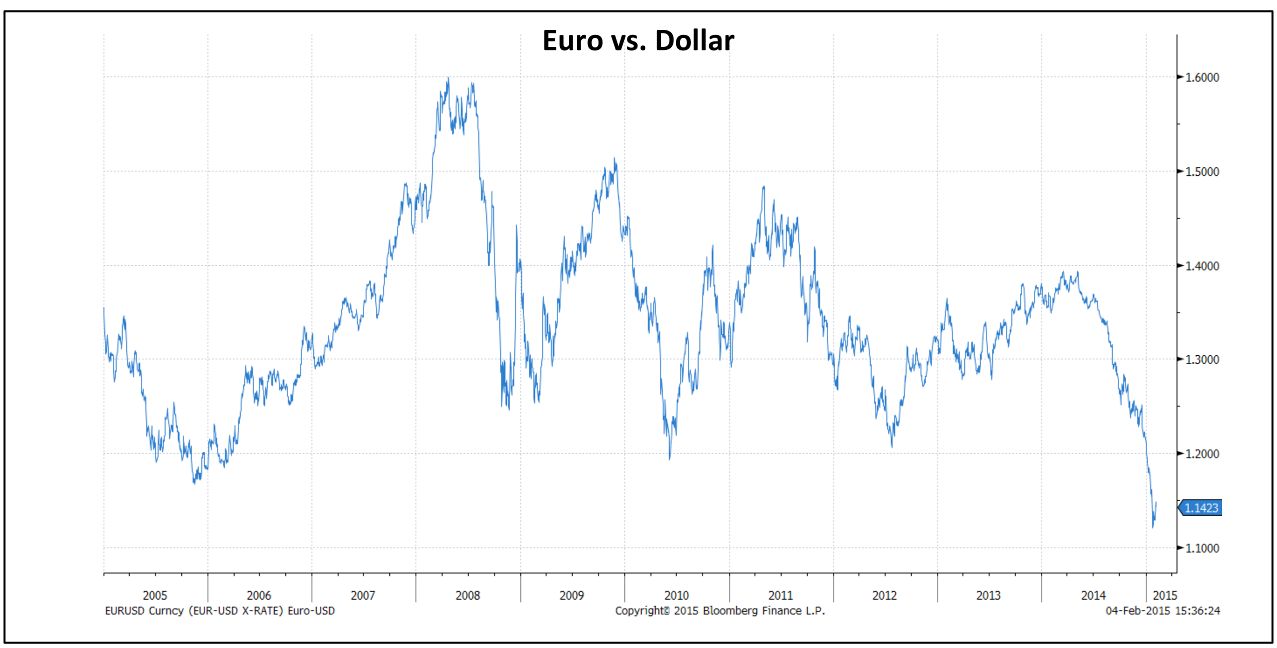
Our friends at Strategas Research Partners recently pointed out they are "starting to see evidence that a cyclical trade may be developing across Europe." That means they see stocks that have traditionally benefitted early in an economic recovery acting better, rather than the more defensive stocks a portfolio manager would hold if they were worried about the economy. Their charts (noted on the next page) point out recent price movements in European small caps, autos, retailers, construction companies and industrial stocks may be a precursor to better performance for the European economy and markets.

Improvement for European Cyclicals

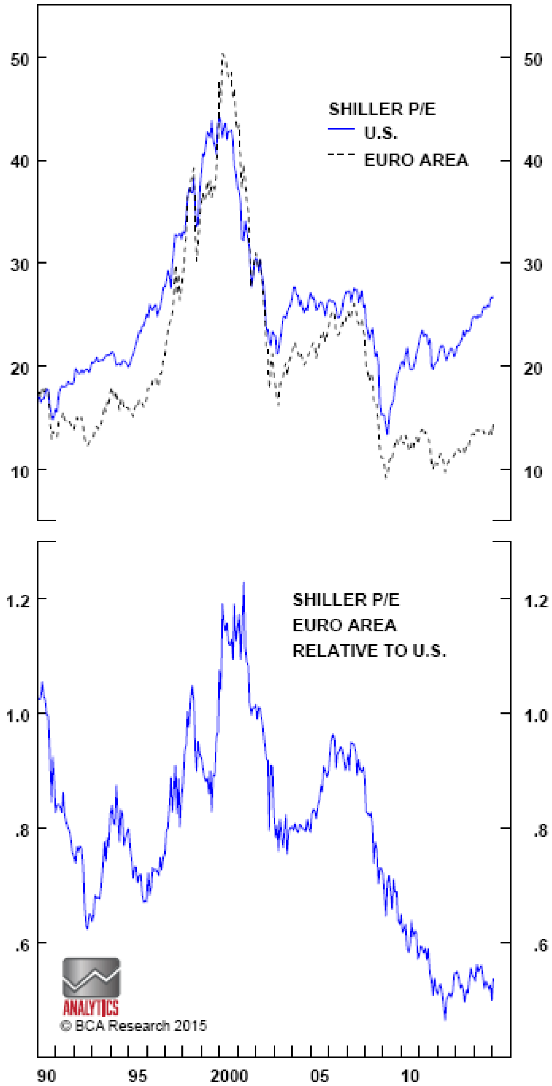


Source: Strategas

How could Europe see better economic growth? Well, the decline in the currency has made their products much more price competitive in world markets. The Euro has depreciated over 16% versus the dollar in the past year. Our sense is that this decline in value has brought the Euro to a new equilibrium which would be (in broad terms) between 1.10 and 1.25 Euro to the Dollar. We don't think there is significantly more depreciation of the Euro from these levels, but current levels still make them a formidable export competitor in world markets.



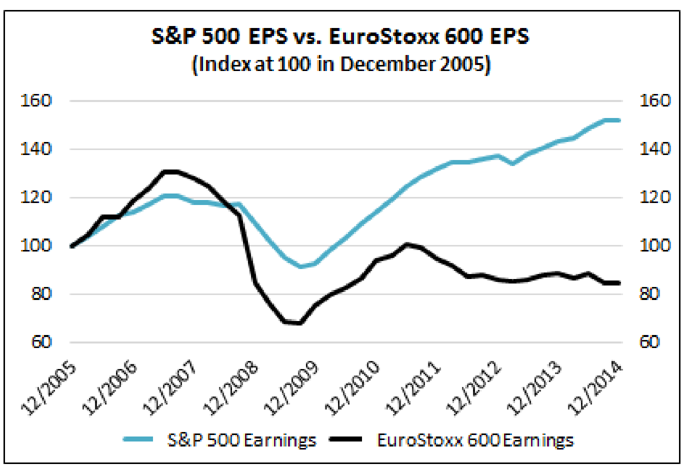
Shiller P/E US vs. Europe

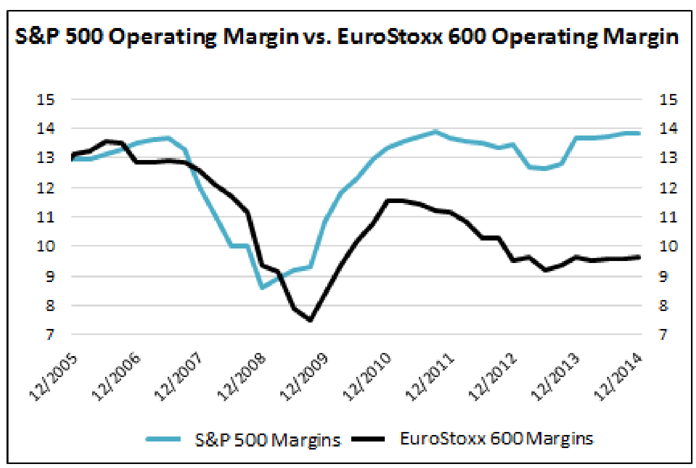


We find current European valuations attractive versus US stocks. There are two reasons for this. First, valuations based on long term P/E's (Schiller's version) have large cap European stocks trading at a significant discount to their US counterparts, as shown in the chart to the left from the Bank Credit Analyst. The second reason is because large cap European earnings and margins are still very depressed, especially when compared with the S&P 500. We believe European companies have the potential to see margins recover dramatically, as long as some modest level of GDP growth occurs. Margin improvement should drive better relative EPS and stock performance in Europe.

S&P 500 operating margins have rebounded from 9% to 14% since 2008 while the EuroStoxx 600 margins have remained stagnant. Over the next few years we expect better European margins due to:

- Lower oil and gas prices providing more spendable income.
- An improved economic outlook as Quantitative Easing spurs investors to seek investments that help the economy grow.
- A pickup in economic growth as the fiscal drag of austerity is reduced.
- A cheaper Euro providing a boost for exports, and:
- Less deleveraging pressures as that process is nearly complete.





Source: Bloomberg and Todd Asset Management

We could go on for many more pages with charts and graphs, but we think you understand our position. The quantitative easing program announced by the ECB is a game changing event and likely to alter global equity market leadership. This does not change our long term bullish thesis on US stocks, but rather adds Europe to the mix of those regions that are probably in secular bull markets. Trends like these always come in fits and starts, so there is always the potential for a pullback. Nevertheless, we think investors that have benefitted from being underweighted in European markets should probably rethink their position and add to them before the impact of unconventional easing becomes apparent in their economic reports. The Todd Asset Management International Intrinsic Value portfolio is currently overweighted in European companies.

As always, we are here to assist you. If you need any additional information, please feel free to contact any of us.

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