EQUITY

This Isn't the Way Stock Market Cycles Typically End

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European equities are the great unloved asset class. But Dylan Ball, head of European Equity Strategies, Templeton Global Equity Group, thinks that status means there should be some opportunities to be found for long-term investors. He explains why he thinks the current stock market cycle still has some way to run in Europe and why he expects to see an uptick in cross-border merger and acquisition activity.

In our experience, stock market cycles end with a bang, not with a whimper. Typically, the end of a cycle is accompanied by irrational exuberance among investors and ever-increasing merger and acquisition (M&A) activity.

While we certainly appear to be in the late stages of the current cycle in Europe, the general absence of those heady conditions suggests there may be some way yet to run.

Of course, cyclical concerns are not the only considerations that have made European equities the great unloved asset class over recent months. Investors are also wary of the political backdrop in the region, including Brexit, Italian budget disputes, gilets jaunes (yellow vest) demonstrations in France and growing support for extreme political parties.

For us, the sheer unpopularity of European equities in the current environment indicates there should be some opportunities to be found.

A Cyclical-Drive Bounce-Back

Globally equities have bounced back from their nadir at the end of 2018. That rally has been driven by a switch out of defensive sectors such as telecommunications, utilities and health care, into cyclical stocks, like industrials and consumers.

Although, in the short term, passive investment approaches drive much of the market's movement, we believe fundamentals should be a crucial consideration for investors. Over the long term, the stock price should reflect the fundamentals of a given company.

As European equity investors, we're looking at valuation spreads within sectors. A valuation spread is simply the average price of one stock, sector or index versus another, using a valuation metric such as the price-earnings (P/E) ratio.

At the end of last year, as volatility returned to equities, many of the valuation spreads narrowed dramatically across a number of sectors. Momentum took over from fundamentals as the driver for pricing.

That should present an opportunity for active managers to pick companies that appear attractively valued and ride on the valuation expansion when fundamentals reassert themselves. For example, in the banking sector in late 2018, companies that we'd consider stronger players were trading on very similar multiples to their weaker peers.

We aim to use that dynamic as an opportunity to buy banks that appear to be in a stronger position. As fundamentals reassert themselves, as we believe they will, we'd expect the pricing of the "better bank" to improve more quickly than a competitor that might be further behind in their restructuring story.

We think the recovery dynamic still has some way to run in terms of valuations—stocks appear cheap, and we think that is likely to continue. That should be positive news for European equities as Europe's stock markets tend to have a pro-value flavor, given the weight in financials, energy, industrials and materials.

Drivers for European M&A

One of the traditional heralds of the end of a market cycle has been an uptick in M&A activity.

So far we've yet to see such an uptick in Europe, but we think there are strong economic and political reasons why that might change—in particular the need to build European companies that can compete on the global stage.

Up to now, European rules governing monopolies have served to promote national champions. The competition authorities recently blocked the planned merger of two of Europe's largest rail manufacturers, Germany's Siemens and France's Alstom.[1]

Both German Chancellor Angela Merkel and French President Emmanuel Macron had lobbied hard for the deal to go ahead. Despite being regional manufacturing powerhouses, neither Siemens nor Alstom on their own is big enough to compete on the global stage with Chinese or US manufacturing behemoths.

We think Merkel and Macron's support shows there is growing recognition that the authorities in Europe need to facilitate regional champions that can compete with global competitors.

The most likely way for those regional champions to emerge is through M&A. In the future, we'd expect to see some significant cross-border deals, notably in the financials, utilities and telecommunications sectors.

What Are the Risks?

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Value securities may not increase in price as anticipated, or may decline further in value. To the extent a portfolio focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a portfolio that invests in a wider variety of countries, regions, industries, sectors or investments. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments.

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[1] As of December 31, 2018, Siemens common stock represents 1.35% of the total net assets within all the funds managed by the Templeton Global Equity Group. As of December 31, 2018, funds managed by Templeton Global Equity Group own no Alstom common stock. Holdings are subject to change.