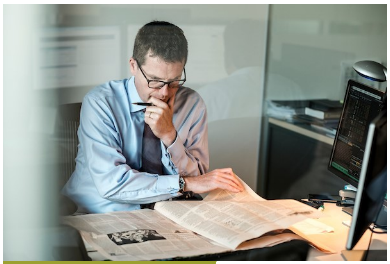


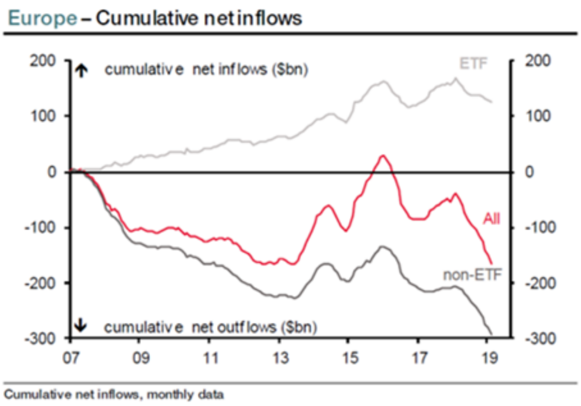
Friday Morning Coffee

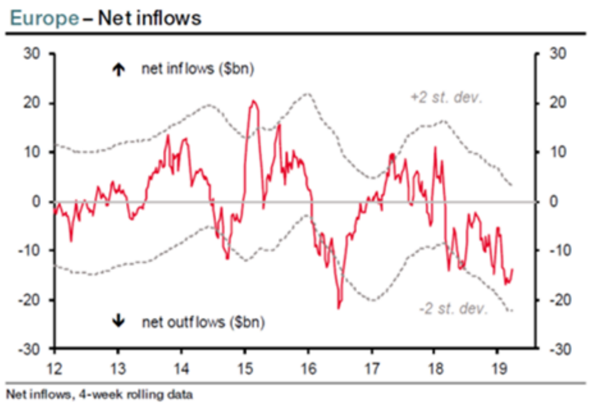
Nr. 54 — The Pain Trade

Here we go again – the words 'melt-up' and 'pain trade' are coming up again in the financial media. This is no wonder as European markets, as measured by STOXX 600 are up 15.8% ytd as of the close of Wednesday this week. Some large capitalization companies, like SAP, have seen twice the performance of the market overall since the beginning of the year. SAP alone added more than 15 bn EUR in market cap on Wednesday after strong results and an announcement of a shareholding by activist Elliott. For the record and to put matters into perspective, this increase in worth on one day represents roughly 25% of the annual GDP of the Grand Duchy of Luxembourg. Are markets overheating ?

As a long-term investor I am inclined to answer with a no, at least not in Europe. What is currently happening has to be seen in the context of the correction of Q4 last year where investors have become excessively pessimistic about equities in general and Europe and European equities specifically. The normalization process we are currently seeing comes as companies enter the Q1 result season. **It is still too early to draw any conclusions, however the first publications appear to confirm our view that European companies are not in an earnings recession as many strategists had feared.** This combined to green shoots appearing like the Chinese Manufacturing PMI, progress on the China-US trade talks and a delay in Brexit is enough to reduce the noise level in the stock market enough so we come back to fundamentals. The cherry on the cake is the low valuation of European stocks.

The remarkable factor in the recent stock rally is however the fact that it is clearly not based on any conviction by investors. As shown in the graph below from SGResearch, European equities are still suffering outflows. The passive investors, represented by the ETF's, are still selling Europe. For active investors in Europe (the non-ETF's) the picture is even worse as investors continue to flee the stockpickers in European equities.





Source: SGResearch

With every day the market showing a positive return, the opportunity cost for investors staying on the sidelines is increasing. With this the pressure builds on the asset allocators to finally build up their weight in European equities. That in turn could drive the European markets up further independently of any valuation or fundamental concerns.

Friday Morning Coffee - Nr. 54 — The Pain Trade

Europe is still the second largest equity market globally behind the US. Its importance has however been fading over the last 10 years and the weight of EU in the global market capitalization went down from 1/3 to currently 20%. The reasons for the dwarfing of Europe are well identified going from inferior earnings growth since the financial crisis, political turmoil and the emergence of Asia, mainly China.

The weight of European equities in global portfolios is now far below the historical average. **At ECP, we are not in the business of market timing. As long-term investors our investment decisions are only guided by our quest for undervalued earning power on an investment-by-investment basis. Here we find ample opportunities in Europe.** If now we would get a helping hand from the ones timing the market and coming back into European equities, we say thank you very much. With a steady hand, we will sell once our fair values are reached.

I wish you a nice weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
April 26th, 2019