

Don't Fear the Bear Market: Trading Below Trend, DM Equities offer Value, especially Europe

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With January's sell-off in oil driving the risk-off trade, most major equity markets have fallen into bear market territory. Fearful of more downside, investors are taking risk off the table. But is the downside potential really that high? Looking back over the past two decades, and covering three market cycles, as shown in Chart 1, we believe such fears may be overdone.

Each equity market cycle over the past two decades has lasted about 6 years, starting with the IPO boom and tech bubble burst (1997 to 2002), the sub-prime mortgage boom and global financial crises (2003 - 2008), and the subsequent recovery phase (2009 to 2014). With developed market equities ending 2015 essentially flat, and with the start to 2016 decisively downbeat, we may have arrived at the somewhat delayed down-phase in this cycle. In the current cycle, we have yet to experience a major sell off similar to the previous two cycles.

In fact, with annualised total return performance (dividends reinvested) for developed markets adjusted for inflation in the 1st and 2nd cycle barely beating inflation, the rise of equity markets in the 3rd cycle appears to merely be a catch-up on 12 years of lacklustre performance.

Hence, when taking into account the sharp sell-off in equities this year, we have arrived at real equity market performance of 4% p.a., trending in line with cumulative returns achieved 27 years earlier (i.e. from 1970 to 1996).

A similar conclusion can be drawn from DM equities' corresponding earnings cycles (Chart 2) where, inflated by exuberant equity finance in the late 90s', and cheap debt finance in the low interest rate years leading up to 2008 financial crisis, earnings came crashing down to leave the inflation-adjusted earnings growth picture for that entire period at a paltry 1.4% p.a. The 7.1% p.a. real growth of earnings in 2009 to 2014, and the 8.5% decline in 2015 means the real EPS trend in the current cycle is below the 3.7% long term trend (i.e. from 1970 to 1996).

It should mean that earnings have not been fuelled by excessive financial leverage, and that significant losses may - similar to the tech bubble in the late 90s - be limited to specific sectors (i.e. energy and mining stocks) and not the broader market.

Capacity rationing keeps Eurozone corporate profitability resilient

In fact, within DM, European equities may, despite being overly exposed to foreign trade, produce stronger financial results than their US counterparts. In the second half of 2015, operating margins within the Eurozone's non-financial corporate sector have remained relatively high, hovering around 12 to 13%, even as these have fallen to around 11% in the US across the same period.

The stark divergence in industrial capacity (see chart 3) helps explain why this is so, expanding by 7% in the US since 2010. At the same time, amidst austerity and a drive within the private sector to pay down debts, industrial capacity in the Eurozone fell by 6% as Eurozone businesses focussed on rationing output. As a result, Eurozone companies are potentially better positioned to sustain higher profitability levels even as global economic growth is slowing down (see Chart 3).

Nevertheless, the Eurozone's improving domestic demand picture for 2016 is likely to create under-capacity problems for Eurozone companies in the near future. By contrast, in the US, after several years of robust economic expansion, growth in recent quarters has started to slow. Coupled with a strong dollar, growth of industrial production is petering out. The steady expansion of industrial capacity now looks overdone, forcing utilisation rates across goods producing industries lower. While a weaker profit outlook emerges for the US, European companies are likely to enjoy better results.

Developed market equities have started 2016 below trend. They now may present a buying opportunity as a sharp correction in share prices suggests an earnings slump is being priced-in. With no evidence of excess financial leverage in DM, the earnings correction is expected to affect mainly commodity producers. In the context of sustainable high operating efficiency and improving domestic demand at home, European equities are seen as one of the favourite asset classes for 2016.

Investors sharing this sentiment may consider the following UCITS ETFs (ticker in brackets):

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- [WisdomTree Europe Equity Income UCITS ETF \(EEI\)](#)
- [WisdomTree Europe Equity UCITS ETF – EUR Acc \(HEDF, HEDG\)](#)
- [WisdomTree Europe Equity UCITS ETF – USD Hedged \(HEDJ\)](#)
- [WisdomTree Europe Equity UCITS ETF – GBP Hedged \(HEDP\)](#)

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