Crossbow Partners
Experience & Discipline

London Trip Report

Climbing the proverbial wall of worry

September 17 - 18, 2018

Executive Summary

Brexit is not expected to pose a major risk to equity portfolios, as managers can prepare for the event and Brexit will mainly be played out through GBP moves

In Europe, the outlook for electricity is still improving and we could see further tightening of power prices in 2019 due to reduced supply, as more coal and nuclear power plants are being phased out

Carbon ETS are poised to appreciate further due to the undersupplied power market in Europe, forcing European producers to switch from coal to gas and hydro power plants

Outflows from European funds have accelerated sharply in 2018 and hit equity fund performance, as global investors cut back their exposure, spooked by uncertainty over Italy's future and fears over spillover effects from Turkey on European banks

Value stocks with a quality bias were hurt most by the ongoing preference of growth over value, as they suffer from multiple compression, even though their earnings have not deteriorated

European equity markets will benefit from slow, but steady GDP growth, low interest rates, and an improving jobs and earnings picture, while the trade wars, fund outflows and a stronger EUR may have a dampening effect

The micro story of financials is very supportive for a re-rating, as they come with historically low multiples and an asymmetric upside return potential in an environment of rising asset prices and upcoming rate hikes

Macro and Equity View

1. 4Q 2018 will be a crucial quarter for markets

Global economic growth is solidly underpinned by robust growth fundamentals both in the U.S. and, albeit to a lesser extent, in the rest of the world. Small wonder that equity indices in the U.S. are clocking new record highs, propelled higher by strong earnings, the windfall benefits of the U.S. tax reform, record low unemployment and low inflation. At its recent September meeting, the Fed had upped its growth forecast for 2018 (+3.1%) and now also expects strong growth in 2019 (+2.5%) and 2020 (+2%). Only a few economists remain that predict an economic slowdown in 2019 and beyond. While the economic picture looks rosy, the spectre of escalating trades wars weighs on sentiment and political risk is on the rise.

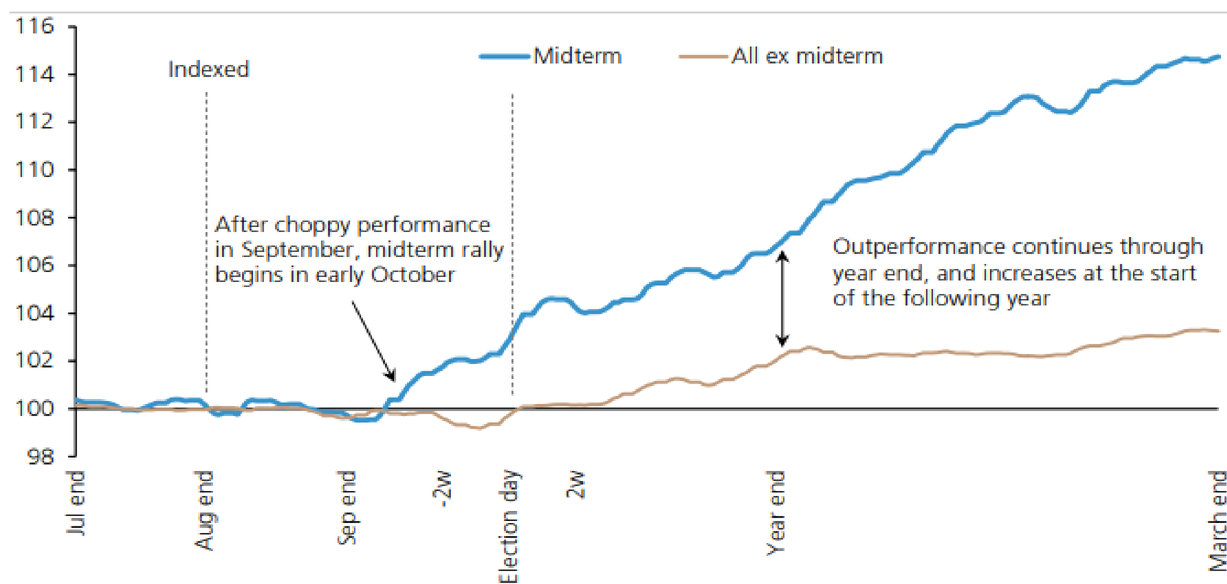
With less than 30 days to go until the U.S. midterm elections on November 6th, political uncertainty is rapidly mounting. The elections are looming large on the horizon of investors, as they will be shaping at least the next two years. All 435 seats of the House of Representatives and 35 out of the 100 seats of the Senate will be contested. Forecasters and market consensus are predicting a tight race. The current consensus view is that we will have a divided Congress – with the House taken by the Democrats and the Senate remaining under Republican control. But as the polls are substantiated by thin margins only, we could also be facing a Blue Wave (Democrats take over both the House and the Senate) or a Red Wave where the Republicans retain control of both institutions. While it seems futile to speculate on the outcome, it might make sense to look at the big picture and to understand why the midterms matter. Shifts of balance of power in Washington could entail meaningful implications for both fiscal and foreign policy.

If the status quo is maintained and the Republicans hold Congress, they could revive their legislative agenda and seek to pass sweeping new laws, i.e. further de-regulation, another attempt at repealing Obamacare or cutting back on welfare, food stamps, Medicare, or social security. Or they could try to deliver more tax cuts. By contrast, if we get gridlock – i.e. the Democrats take over either the House or the Senate – or if the Democrats were to take the Congress, they would likely block all those Republican ambitions, and the consequences would probably be: No more de-regulation, no Obamacare repeal, no major cuts to welfare, and no more big tax cuts for corporations and the wealthy. But, even more importantly, they could gain new powers to investigate the Trump administration and to block Trump's nominees from being confirmed. Many Republicans are also betting Democrats will investigate President Trump's tax returns and his dealings with Russia, while an outright impeachment seems a distant option only. Many investors are inclined to believe that a Trump administration that is reined in by the checks and balances of a divided Congress is good for markets.

Rather surprisingly, though, none of it may matter too much to investors if history is any guide, as recent studies by UBS and Deutsche Bank suggest. The UBS thought piece expounds that the S&P 500 has rallied an average of 14.5% from the end of August to the end of March around midterm elections. After a rocky start marked by a median decline of 1.4% from the end of August through early October, markets tend to rally through year-end and into the next year. Moreover, the rally in equities around midterm elections has been much stronger than the average returns seen in all other years. One of the reasons that the S&P rallies appears to be the fact that investors apply a 10% discount to the market given the political uncertainties

revolving about which candidate and policies will prevail. Once the winner is known, the discount gets wiped out. As an aside: A study by Citi's Private Bank also points out, however, that some sectors behave differently. Before the elections more defensive sectors such as health care and consumer staples tend to do better than cyclicals which move largely in line with the overall economy.

Figure 1: S&P 500 performance around midterms vs all other years (average)



Source: Haver, S&P, UBS

The Deutsche Bank study looked at a shorter time window around the elections and noted that the three-month period running from a month ahead to two months after the election has produced a median 8% gain. And that includes only one decline, a 4% drop in 1978, over that period in the last 21 midterm years.

Obviously, this looks like good news for bulls. But, of course, history is only a guide. And the researchers also highlighted that statistically it was not clear whether past performance in those periods was largely driven by politics and uncertainty or by other traditional drivers such as economic growth and earnings that might also explain the rallies around the midterm elections. In addition, seasonal factors also provide a tailwind and if you control the results for growth and seasonality, the performance attributable to the midterm elections between October and December is slimmer than it first appears. Thus, midterm election years statistically deliver a favorable backdrop for equities. Yet the overall economic environment must be equally supportive and earnings growth, consumer confidence, low rates, and low inflation are also important performance drivers. As all these factors are in place in 2018 and the windfall profits from the U.S. tax cuts as well as the de-regulation measures are here to remain at least for the near future, analysts are quite constructive on markets – even if the Republicans were to lose both chambers.

The upcoming Brazil presidential elections in October is another event that has the potential to roil emerging markets and, potentially, also developed markets. Emerging markets have suffered this year, as escalating trade tensions threaten to curb global economic growth and a strong U.S. dollar has notably hit emerging market countries with a large foreign debt burden. The turmoil in Turkey and Argentina this year has been considered an isolated event largely

confined to those two countries. In this context, the Brazil presidential elections could revive fears of a spillover, as the likelihood of a market friendly outcome in the first round of the Brazilian election did not materialize, as no candidate was victorious. A decisive second round will be necessary. In the highly polarized country, analysts expect a bitter, divisive second-round contest between the far-right (Jair Bolsonaro) and the far-left (Fernando Haddad) candidate that has the potential to shock markets out of their complacency, as neither of the candidates seems to be poised to put urgently needed fiscal reforms on his agenda. Bolsonaro would be preferred, as he has appointed a very traditional and orthodox finance minister. The initial reaction would be positive. Yet markets are likely to react badly even to Bolsonaro if both fiscal discipline and reforms are not adopted and he does not reassure investors. After an initial honeymoon, we could see the Brazilian stock market plummeting – as the Real already has. This, in turn, might lead to an escalation of the emerging market debt and currency crisis, as the near-term outlook for Latin America's biggest economy is not rosy in either case.

And, finally, the third event that could make or break the quarter for investors is the populist government in Italy, attempting to bankroll its political program by proposing a draft budget deficit of 2.4% to the EU for 2019 (and of 2.1% in 2020 and 1.8% in 2021). This could put an end to the previous government's effort to reduce the overall government debt to a more manageable level. Markets now seriously question whether Italy is in a position to stabilize government debt (131%) at a threshold in line with Portugal. The Italian government claims that the fiscal spending in 2019 will jumpstart the economy and lead to economic growth of more than 1.5% in the following years – which they hope would eventually allow them to achieve a debt reduction after 2020. Markets are more than doubtful that these ambitious goals are realistic and have dumped Italian assets. The MIB Index, bank stocks, the European banking sector, and Italian government bonds were all indiscriminately sold. The spread between Italian and German government bonds spiked towards 300bps, while the EUR weakened against the USD und the Swiss franc. And it sets the Italian government up for a confrontation with the EU institutions which have to approve the budget. Yet these negotiations are expected to turn out to be difficult, as the budget does not seem to comply with EU rules and not many budget items appear to stand for sustainable growth. So far, the Italian budget story has been an insulated event that has mainly hit Italian and Italy-related assets in Europe, but, clearly, Italy will be facing more turbulent times in the weeks ahead. This means for investors that more uncertainty and market volatility are looming on the horizon. Italy is simply "too big to fail" for the EU: If the populist government were to adopt extreme measures, markets would roll-over. There remains still little chance Italy will default, look for a re-denomination or move to exit the EU, but all would be catastrophic for investors.

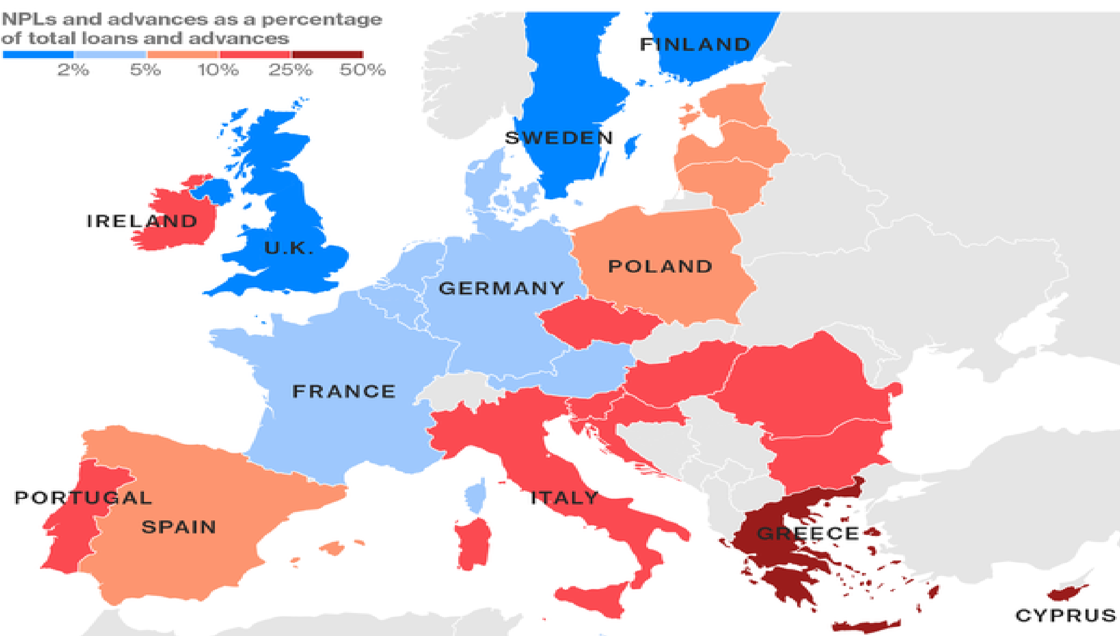
2. European Financials Revisited

The financial sector in Europe is one of the industries that does not only trade at a discount to their U.S. peers, but it is also one of the sectors that has not really recovered since the financials crisis. It has even consistently underperformed European equity indices since 2009. This is highly unusual, as banks have typically led recoveries in the past.

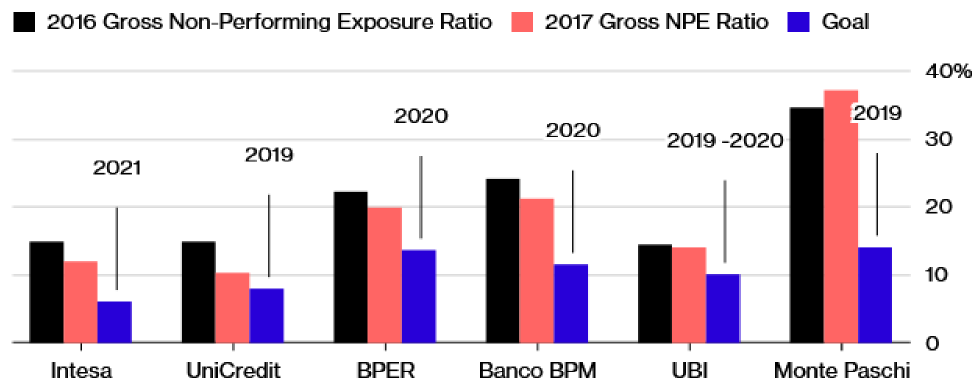
The managers of our financials funds now believe that the industry may have reached a tipping point in Europe, as the micro story in European banking looks quite compelling. They see tailwinds both from asset prices that have started to rise again and from European bank lending

that is accelerating across the Eurozone. In addition, banks have been forced to make enough provisions to deal with their NPLs and to replenish their capital base. Common equity tier 1 has risen from 11.6% to 14.1%. Barring a new systemic crisis, the massive recapitalization of major European banks (such as Deutsche Bank, Credit Suisse, Unicredit, and Monte dei Paschi di Siena) has largely put the solvency issues behind us, but it has also led to a massive dilution for shareholders. And more regulatory tightening is no longer in the cards, after the Trump administration has started to repeal and prune some of the regulatory excessiveness in the U.S. Earnings expectations are relatively stable and capital is being returned. Investors are likely to refocus on the increasing likelihood of rate rises in 2019. Higher rates and a steeper yield curve will be beneficial for banks with their high operational gearing, after negative interest rates have put additional pressure on European bank profit levels.

The clean-up of bank balance sheets is another positive trend for investors, as NPLs are being rapidly reduced. The creation of a bad bank in Spain (and plans for such a vehicle in Greece) as well as strong regulatory pressure on banks - notably in Italy and Portugal – prompted financial institutions to step up writedowns on bad loans and to dispose of them at reasonable prices. In a recent briefing, the Bank of Italy pointed out that bad debts held by lenders, net of writedowns, fell to EUR 54.5 bn in February 2018, from EUR 59.5 bn the month before and EUR 64.1 bn in December 2017.

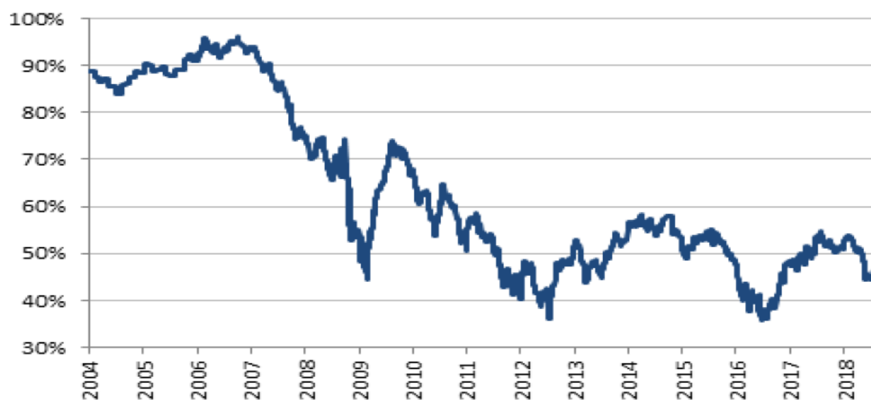


While the problems are being tackled, they are not yet solved. But if the banks continue to execute on their aggressive NPL disposal plans, they will be cleaning up their balance sheet and returning to dividend paying status. And, clearly, we will see more consolidation in the space, as notably cross-border mergers are expected to happen due to cost pressure.



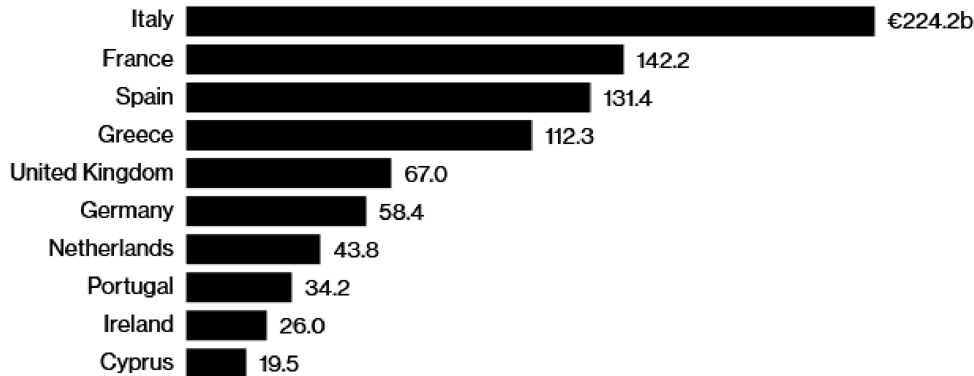
Source: Company filings
Note: Paschi's 2017 ratio would be 21% when including a major planned portfolio disposal

Valuations of bank stocks also look attractive, with many banks trading at around half tangible book and some peripheral banks in cases as low as 0.3x, implying the need for additional capital and perpetually low profitability. Something that our managers consider rather unlikely. They see considerable upside for banking stocks if the recovery in Europe goes on and we see a normalization of rates in the near future and as consolidation takes place.



Source: Tosca

Clearly, the micro story sounds intriguing. But what has been frustrating for investors are the strong macro headwinds that have hit the sector time and again since the financial crisis. Earlier in the year, macro news flow dominated the sector with fears over trade wars, the shrinking of the Fed balance sheet, a slowdown in China, the emerging market crisis in Turkey, Argentina and South Africa, and, most recently, politics in Italy. Against this backdrop and the escalating budget story in Italy, it is easy to understand why investors shy away from banking stocks. In 2017, European banks held EUR 944 bn of non-performing loans, weighing on their balance sheet and hurting their earnings. Investors are also worried about the so-called “doom loop” between European banks and governments. The vicious cycle occurs because banks hold sovereign bonds in their portfolios and when a country loses market access, the value of bank portfolios falls dramatically and they need help from the government to stay solvent.



What is special about Italy is the fact that Italian banks made progress towards cleaning up their balance sheet, yet continue to add BTPs to their holdings of sovereign debt. Italian government debt held by Italian banks was up 12% this year to EUR 374 bn in August according to the ECB. This is partly due to the re-financing operations of the ECB which has required significant collateral such as BTPs, but also due to the so-called GACS programme which provides a guarantee to buyers of senior tranches of securitized NPLs. Thus, any actions by the populist Italian government that frighten markets might revive the “doom loop”. Meanwhile, the potential for a downgrade to Italy’s debt rating from BBB to one or two notches lower is also eroding confidence in Italian assets. While it is unlikely that Italy will lose its investment grade rating at this point in time, the downgrading is another warning sign that uncertainty and potential spill-over effects hurt market sentiment. Clearly, Italy has the potential to create a lot of volatility and to deal a serious blow to the EU, the EUR, and Europe as a whole.

What does it mean for investors? You have to believe that interest rates in Europe will normalize before the next recession occurs, that the Italian government will find a reasonable compromise with the EU, that the Italian issue will remain contained, and that there will be few severe spill-over effects from emerging markets. Then, as time passes by and the issues above are resolved or smoothed over, investors will refocus on Europe’s solid growth, rising asset prices, the upcoming rate hikes in 2019, and the low historical multiples of financials. With the solvency crisis behind us, investors should focus on the exceptional asymmetric upside return potential of a beaten-down sector and the dividend paying status of the financials where a rapidly growing stream of dividends is in the cards. And (cross-border) consolidation due to capital, margin and cost pressure is only in its infancy, as the financial map of Europe will be redrawn.