Weekly Market Commentary

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Don't Fight the ~~Fed~~ ECB? (Part 1 of 2)

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Highlights

Buying stocks after the various QE programs were announced by the Federal Reserve was generally a profitable decision for investors.

To answer the question about whether the ECB programs will have the same impact on European stock markets, we point out some key differences between the United States then and Europe now.

Next week, we will take a deeper dive into the investment opportunity in Europe and evaluate fundamentals, valuations, and technicals, none of which we find particularly compelling at this time.

The European Central Bank (ECB) announced bold stimulus measures, including further cuts to key interest rates and an asset-backed securities (ABS) purchase plan, on September 4, 2014. The moves are an acknowledgment of the recent deterioration in the Eurozone economy and increased deflation risk. This decision follows the historic move to negative deposit rates initiated back in June of 2014. These measures are geared toward spurring economic growth through easier access to cheaper credit for businesses and households and toward driving prices higher to avoid deflation. These moves may also continue to pressure the euro currency and help boost European exports.

Is this move by the ECB a buy signal for European equities? To help answer that question, we look back at how U.S. stocks reacted to our own monetary stimulus through quantitative easing (QE). Although Europe has not engaged in outright QE (where the ECB buys government bonds directly), it may in the future. With essentially zero interest rates (or lower), and the addition of bond purchases, these ECB moves are similar to the Federal Reserve's (Fed) moves.

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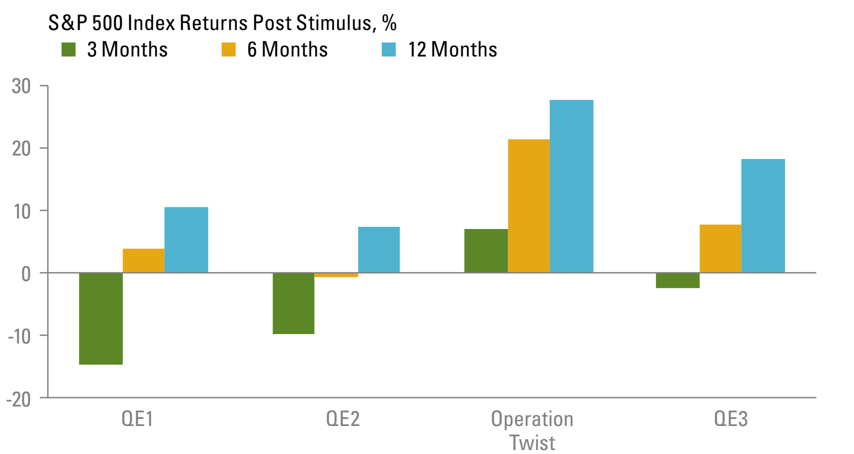
1 U.S. Stock Markets Generally Responded Well to QE



Source: LPL Financial Research, FactSet 09/12/14

Past performance is no guarantee of future results.

Dates of Federal Reserve stimulus programs: QE1 — November 26, 2008; QE2 — November 3, 2010; Operation Twist — September 21, 2011; QE3—September 13, 2012.

earlier programs (QE1 in November 2008 and QE2 in November 2010) turned out to be less compelling opportunities [Figure 1]. Except for Operation Twist (where the Fed sold shorter duration securities to fund the purchase of longer-dated ones to keep long-term interest rates low), announced on September 21, 2011, it really took about a year for the stock market to react positively to the Fed. It is worth noting, though, that some market gains came in anticipation of these program launches. In addition, the expansion of QE1 that came in March 2009 that added U.S. Treasuries to the program did coincide with the stock market's strong rally off the bottom beginning on March 10, 2009.

Does this mean buy Europe now? Not necessarily. To help answer that question, we think it is important to point out some key differences between the United States then and Europe now:

- **Growth.** The U.S. economy was growing faster than Europe is now when each of the three post-recession programs was announced (QE2, Operation Twist, QE3). The U.S. economy has been at a 2% annual run rate or better for real gross domestic product (GDP) since QE2 was announced in fall 2010, and we believe it is poised to accelerate. Europe has been growing at just a 1% pace since emerging from recession in 2013 and is at risk of tipping back into recession.
- **Valuations.** U.S. stocks were cheaper when these Fed programs were announced than Europe is now. As of September 1, 2014, the MSCI Europe Index is trading at a forward price-to-earnings ratio (PE) of 14.2 [Figure 2]. Except for a brief period in late 2009 when the S&P 500 forward price-to-earnings ratio was inflated by depressed earnings shortly after the recession, the S&P 500 traded below that 14.2 PE level during QE1, QE2, Operation Twist, and the majority of QE3.
- **Profits.** At a similar point in the business cycle roughly one year after emerging from recession, U.S. revenues and earnings were growing at a much faster rate than Europe is currently. In fall 2010, S&P 500 revenues were growing by 10% and profits were growing at a greater-than-20% clip. Europe in the latest quarter (Q2 2014) did grow earnings 11% year over year, but revenues were down 1% and are expected to be flat in 2014 (versus 2013) based on the Thomson-tracked consensus for the STOXX Europe 600 Index.

Forward price-to-earnings is a measure of the price-to-earnings ratio (PE) using forecasted earnings for the PE calculation. PE is a valuation ratio of a company's current share price compared to its per-share earnings.

Although we would view the ECB stimulus positively, these differences, and the fact that the impact of ABS purchases may not be as wide reaching as outright QE, tell us not to overemphasize the ECB in making decisions on Europe.

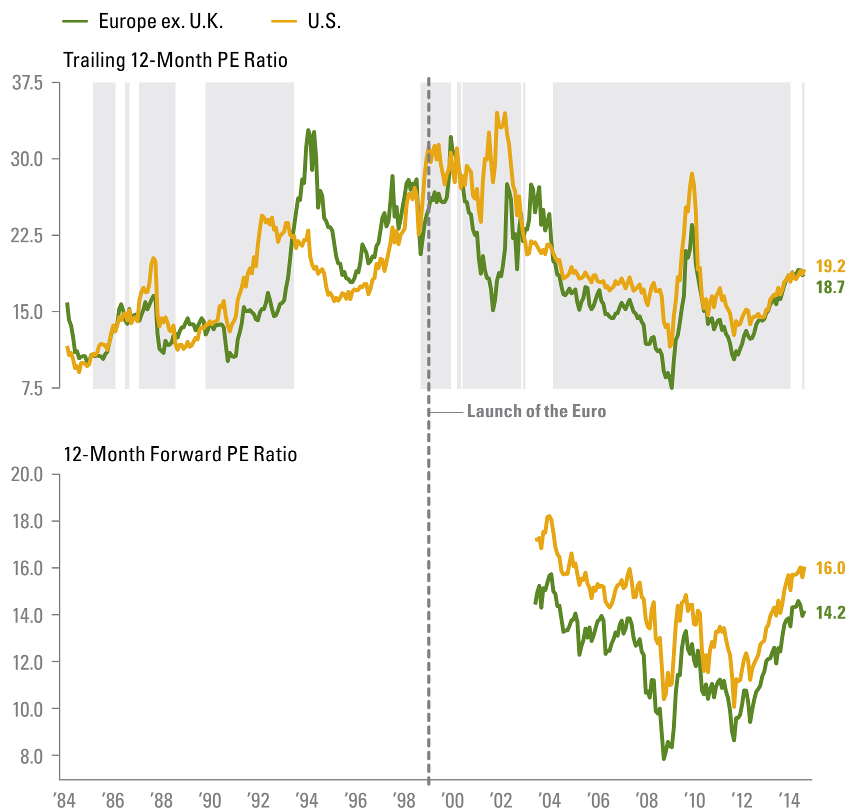
Instead, we turn more broadly to our investment process, with its emphasis on fundamentals, valuations, and technicals, and look at some of the key factors in shaping our view of the European equity markets, including:

- growth and inflation outlooks,
- loan demand,
- earnings risk,
- geopolitical risk,

- relative valuations, and
- technicals.

We will discuss these topics in next week's *Weekly Market Commentary.*

2 European Stocks Deserve a Bigger Discount to U.S. Stocks Than They Are Getting



Source: LPL Financial Research, Ned Davis Research, MSCI 09/12/14

Monthly data from 01/31/84 to 08/31/14.

Shaded areas indicate periods when Europe ex. U.K. is cheaper on a trailing PE basis.

Past performance is not indicative of future results. Indexes are unmanaged and cannot be invested in directly.

Conclusion

The additional stimulus provided by the ECB may help improve the growth outlook for Europe, but we do not believe that it is enough to make a strong case for a positive view of European equities at this time. Next week, we will take a deeper dive into the investment opportunity in Europe and evaluate fundamentals, valuations, and technicals, none of which we find particularly compelling at this time. For now, we would recommend "fighting the ECB" and would not take the announced ABS purchase plan, or the possibility of QE in Europe, as a cue to buy European equities. We continue to favor the United States over Europe (and emerging markets as well), but we will continue to watch for opportunities to go into developed markets overseas later this year and in 2015.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock investing involves risk including loss of principal.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The MSCI Europe Index captures large and mid cap representation across 15 Developed Markets (DM) countries in Europe.

The STOXX Europe 600 Index is derived from the STOXX Europe Total Market Index and is a subset of the STOXX Global 1800 Index. With a fixed number of 600 components, the STOXX Europe 600 Index represents large, mid and small capitalization companies across 18 countries of the European region.

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