Political and deflation risks are still casting shadows over Europe

Positive start to the year for the Italian stock market thanks to small/mid caps, while financial stocks still undervalued in the large cap category, observes Banor Capital

by Luca Damiani

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The greatest political risks are still being seen in Europe, especially the forthcoming French elections. To find a definitive solution for Europe's problems a reform and liberalisation programme will be needed, to kick-start the economy and see off the danger of deflation, a threat that has returned in these early months of 2017. As for the stock markets, American valuations are higher than in Europe. And the outlook for Chinese equity is still interesting, in spite of the waning effects of the government in Beijing's expansive fiscal policy. In Italy we're seeing a strong rise in prices for small/mid caps, thanks not least to the regulations on individual saving plans (PIRs), while large cap financial stocks remain undervalued as a result of the continuing negative momentum. This is the wide range of topics addressed by **Luca Riboldi**, advisor for Banor SICAV's Italy Long Short Equity fund and Chief Investment Officer (CIO) at Banor SIM.

Which side of the Atlantic are the biggest political risks coming from, and how should investors protect their portfolios?

In our opinion, still from Europe, especially France and Italy. A victory for Le Pen in France would be a catastrophe for the euro zone, just as a success for the Five Star Movement in future Italian elections would also be a cause for concern. Our feeling right now is that a victory for Le Pen is highly unlikely. That said, however, the best way for investors to protect their portfolios is to buy short-term government bonds of the strongest European countries, because if she did win that would lead to a significant widening of the spread for the weaker economies, Italy first and foremost.

In Europe, the inflation rate has been moving downwards in these early months of the year. Do you expect the risk of deflation to raise its head again?

A few months ago it looked as though long-term inflation was edging back up towards 2% but then in the last few weeks it's slipped back. We agree with Draghi's recent statements to the effect that monetary policy must remain expansionary, because we're not yet out of the range of deflation. We haven't seen any marked rise in inflation in the United States either. However, core inflation there is higher than in the euro zone because the expectation is that the new Republican administration will adopt an expansionary fiscal policy, now that the monetary policy has produced its effects and the economy is back on a healthier footing.

How much longer will it take for Europe to see real interest rates rising again, as is happening - slowly - in the United States?

For the European economies to resume growth, the peripheral countries will need to implement reforms and liberalisation measures. The sooner they're implemented, the sooner we'll see an improvement in the economic situation, i.e. a fall in unemployment and higher wages and inflation. It remains to be seen who'll win the German elections, because Shulz takes a more favourable view of an expansionary fiscal policy than Merkel does, so a Schulz victory would be positive for the European economy. In any case, to see a rise in real European rates we'll need to wait another 12/18 months.

In 2004/2006 we witnessed the "Greenspan Conundrum" in the United States: the unexpected fall in long-term rates at the same time as the Fed was raising short-term rates. Do you think that could happen again in the coming years?

What happened then was a flattening of the curve, which pointed to an increase in the risks of recession. With hindsight, we can say that in those years America was preparing the ground for the 2008 financial crisis; the markets' interpretation of the signals that the real estate sector was seriously over-heating was correct. That could happen again now, because it's fairly typical, before a recession, to see the curve flatten or even reverse.

Recently, we've seen fewer comments,

at the enthusiastic and the catastrophic ends of the scale, on the Chinese economy. What's the situation on the credit and stock markets?

Growth in the domestic economy has been supported by the wholesale expansionary fiscal policy that the Chinese government decided on at the end of 2015. However, the effects of that should lessen from the second half of 2017, and then fade out altogether in 2018, so we expect a slight slowdown. Stock market multiples are still interesting with respect to the rate of growth of Chinese returns and compared with the situation in the western economies, especially if we consider that China at present accounts for 3% of the MSCI World index, and almost 20% of the global economy.

What trends are you observing in investment flows in 2017, in terms both of geographical regions and asset classes?

In the first quarter of 2017 share funds performed well in terms of income, at 1.1%, but less well than bonds (2.1%), in spite of the latter's disappointing performance in the early part of the year. In the fixed income segment, in regional terms the only negative note is euro zone government bonds (-3.1%), while flows for American government paper are still in positive territory (+3.5%) and interest in emerging market bonds is growing (+4.1%).

For the time being, therefore, investors are still opting for the bond markets, both because they remember the excellent returns, with low volatility, achieved over the last 30 years and because of the uncertainty over future inflation trends. We'll probably see significant outflows from fixed income funds only if we have a particularly bad half-year, with losses in the range of 4-5% on bonds.

Do you think American and European share valuations have got too high?

Our analysis of evaluation levels is linked to interest rates. In the United States the Shiller P/E (price-to-earnings ratio) currently stands at 26, the same level as in 2007, just before the financial crisis erupted. However, it's very far from the 35 that it had reached before the collapse in 2000. While it's true that we've returned to the levels of 2007, it's important to note that interest rates were much higher then than they are now. This indicator is inversely proportionate to rate levels, since the lower the rates the higher the Shiller P/E, and vice versa. Indeed, if we consider the adjusted P/E, the value currently stands at 18.3, compared with an average of 16, so valuations on the American market are certainly not cheap, but they're supported by the current low level of real rates. The situation in the European stock market is more interesting, with a current Shiller P/E of 15 compared with a historic average of 14.5; however, the political risks I mentioned earlier could affect that.

In the first quarter of the year the Italian stock market partly made up the losses made throughout 2016. What are your projections for the coming months?

We're cautiously optimistic. In Italy there have in effect been two markets in these early months of the year. There's the small/mid cap market, which has done very well, thanks primarily to the flows arising from the regulations on PIRs. And then there's the large cap market, which has performed less well. If we look at the small/mid cap market in more detail, on the one hand we have fairly high valuations for stocks of high quality and more globally oriented companies, like Brembo and Interpump. And on the other, some that were very undervalued, like Mondadori and RCS, have performed very well indeed and returned to their fair value. As for the large cap market, banks and insurance stocks are still undervalued but the momentum, in terms of yields, is extremely unfavourable because rates will stay low for a long time to come in Europe. So it's hard to see financial stocks performing well until rates begin rising again or the economy recovers.

It looks as though the OPEC cuts are beginning to take effect, with some analysts pointing to a reduction in oil stocks outside the United states. How do you view the situation on the oil market?

Leaving aside geopolitical questions such as the recent tension caused by the American bombing in Syria, which are very difficult to predict, the effect of OPEC's cuts has been to keep the oil price above 50 dollars a barrel. However, there are still two negative factors: the strong dollar and the continuing growth in shale oil production in the United States. With regard to the dollar's performance, given that historically the US currency has had a negative correlation with oil, we expect that if it stays high, at the current levels of 1.05 to the euro, oil will probably fluctuate in the range of 45 to 55 dollars a barrel. However, if the dollar weakened to around 1.15, we could see fluctuations at a higher level, of 55 to 65 dollars a barrel.