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BIG Thinkers

A Global Outlook

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By Drew Voros

EUROPE
A TOO-POPULAR TRADE?

INVESTORS POUR INTO EUROPE AS IT BEGINS ITS RECOVERY, WHICH CAN BRING ITS OWN RISKS

As the Europe Central Bank plows ahead with its own monetary easing program, we're starting to see the results, with Europe outperforming the U.S. and much of the world in terms of economic recovery and stock returns. So it's not surprising that investors have begun to pile into the region.

We talk to two global macro experts—David Garff, managing director of California-based Accuvest Global Advisors; and Neil Azous, founder and managing member of Rareview Macro—for their takes on the region and what investors should be looking at and concerned about.

NEIL AZOUS

Founder/Managing Member
Rareview Macro; Stamford, CT

What's your take on Europe now and going forward?

When you look at why you should be more bullish Europe versus other regions, you have the whole concept of a multiyear mean reversion—meaning, we've been overweight U.S. assets for quite some time, and underweight European assets structurally for quite some time. Think about that in a statistical term: Back in 2008, stock market capitalization of the U.S. exceeded that of Europe by $1 trillion. Seven years later, the U.S. market is now over $10 trillion in market cap larger than European equities.

That mean reversion just in dollar terms is so wide that it doesn't take a lot to see that outperformance in their asset prices.

How does an investor take advantage of that view, if they agree with you?

In its most generic and top-down sense, being long the European indexes with a bias towards the German equity market—the DAX—on a currency-hedged basis where you don't take the brunt of euro volatility, up or down, is the simplest and most beta approach to gaining exposure to that.

If you want to narrow it down further, you can find yield in Irish REITs. Where can you get value? In the Swiss Market Index. Where can you get outright market beta? In the Spanish equity market, at the whole.

There are a wide variety of opportunities, but in its most generic sense, if you want to gain exposure, you should just buy an ETF that gives you broad market exposure to the main engine of Germany or the broader European on a currency-hedged basis.

When you look at Europe, what are the first metrics you look at?

There are two things that go hand in hand. The first one is called the European Central Bank's quarterly lending survey. That is not widely disseminated in the media or on a Bloomberg terminal. You actually have to go to their website. It comes out once a quarter, two to three weeks in arrears.

That is, to me, the most important data set. It's the equivalent of what we call in the U.S. the Federal Reserve lending survey. And what it basically does is give you all the credit metrics to nonfinancial institutions and households. It tells you, in a nutshell, if the local citizen is starting to borrow money again, which would portend to an upturn in a credit cycle. That's No. 1.

No. 2 is what's called the European Central Bank monthly bulletin, which builds on that, which includes money growth, or "M3."

The combination of those two reports is really the crux of available credit, and who's borrowing money, and why they're borrowing money, and where it's being channeled to.

So are you seeing more borrowing at these lower rates?

Absolutely. Evidence around where that's going is wide and dispersed. It's not thematic across every bucket. But you're seeing in certain increments or segments borrowing levels or data points that you haven't seen in three and four years. That's been leveraged up because of QE, the lower interest rates and the lower price of crude oil. So you have a very powerful combination of drivers at the moment.

And how does that compare with what you're seeing in that same metric in the U.S. right now?

It's not necessarily an apples-to-apples comparison—the reason being is that we've had easy financial conditions for five-plus years. That is fairly new there. And we've been oscillating at a positive growth story somewhere between 1.5 and 3% for quite some time, whereas, they were coming from a flat-to-small negative base during that time.

And Europe's market is a very export-based one, whereas the U.S. is very service-sector-oriented. And arguably, given that it's a 70% service market, we're considered a closed economy, whereas they're a much more open economy.

Most American investors are heavily invested in the U.S. What should their European exposure be?

Rather than reduce exposure outright to U.S. equities, the opportunity is more on a relative basis now. It's more about having a greater long position in Japan or China or Europe specifically. And broadly speaking, to me, that's the same thing as just saying, "I want to be long world equities or overweight world equities, ex-U.S." And you can take part in that via various ETFs, of course. ●

ETF.com Pick

iShares Currency Hedged MSCI Germany

TICKER	HEWG
EXPENSE RATIO	0.53%
AUM	$1.65 Billion

Azous doesn't pull any punches: Buy Germany and hedge out the euro, he says. That leaves two ETFs—the iShares Currency Hedged MSCI Germany ETF (HEWG|D-53) and the WisdomTree Germany Hedged Equity ETF (DXGE|B-72). Both are excellent funds. DXGE tilts slightly towards manufacturers, while HEWG takes a plain vanilla exposure to the Germany market.

DXGE gets the edge for us because it has higher assets, higher liquidity and the early signs suggest that it tracks its index well. It's penalized in the Factset ETF Rating system for being a new, unproven fund, but we believe its quality will show over time.