Investment Strategy Note

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German equities: The right mix for the market to outperform

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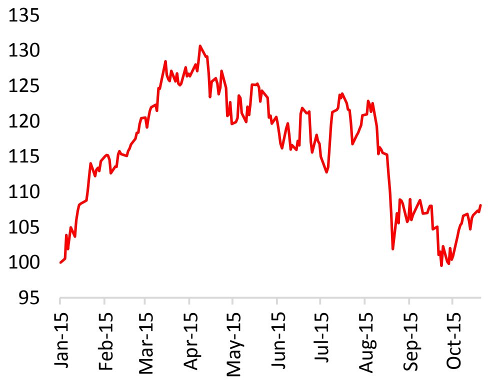
- **German equities have been punished as a result of their relatively high Emerging Markets, especially Chinese exposure**
- **On top of this, negative company specific news flow, such as the VW emissions scandal has dragged the market down further**
- **Despite stabilisation in financial markets, sentiment on German equities remains poor, as such a little bit of good news can have a large impact on returns**
- **The DAX 30 is approximately 13% from the highs it set only a few months ago; we expect that the market has bottomed and will be able to resume its upward momentum**
- **Valuations have come down substantially to around 12x forward PE and compare favourably with other markets as well as its own history**
- **Further support can be expected in the form of ECB policy and the broader Eurozone earnings environment, which we believe looks very promising**

Poor sentiment has created an attractive entry point

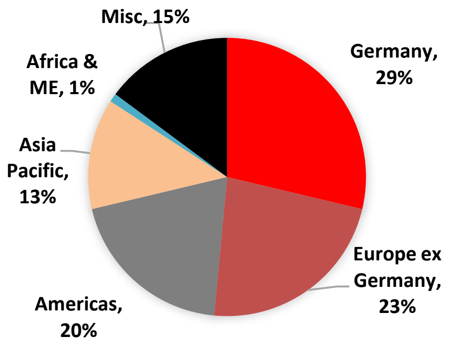
A weak Euro, supportive monetary policy, decent (if unspectacular) economic growth, cheap valuations and undemanding earnings expectations against a backdrop of poor sentiment provides a good platform for German equities to outperform in our view.

Having been the stand-out performer in the Eurozone until May this year, German equities sold off more than most following the recent financial market correction. This is unsurprising given German companies' sizeable revenue exposure to Emerging Markets, the epicentre of global growth concerns. The pie chart below shows that German companies produce almost half of their revenue outside of Europe, with 13% made in Asia. This is high compared with other Eurozone markets such as Italy and France which generated just 6% and 8% of their revenues in Asia in 2014 respectively.

DAX 30 still well below this year's peak



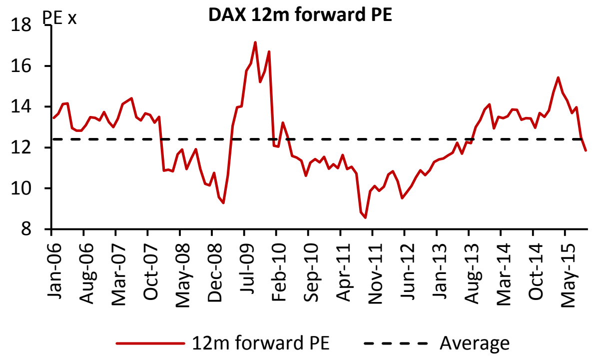
Germany revenue breakdown (2014)



Source: Bloomberg, HSBC, MSCI, Thomson Reuters Datastream

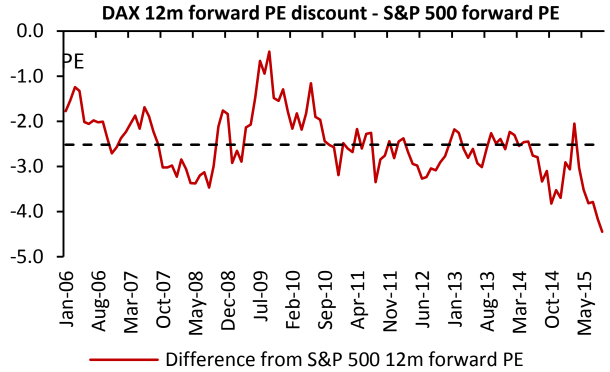
Valuations attractive, earnings growth potential even more so

German equity valuations now look very attractive following a prolonged period of de-rating. The chart below shows that the forward PE ratio for the DAX has fallen from 15.5x in May to around 12x currently, below the long-run average for the market.



Source: Bloomberg

Perhaps more importantly however, is how the valuations stack up on a relative basis. Here, the market looks even better. Using the S&P 500 as a relative, German equities trade at a very large discount to US equities. In fact, the discount is the largest for a long time, something which we believe is unjustified.



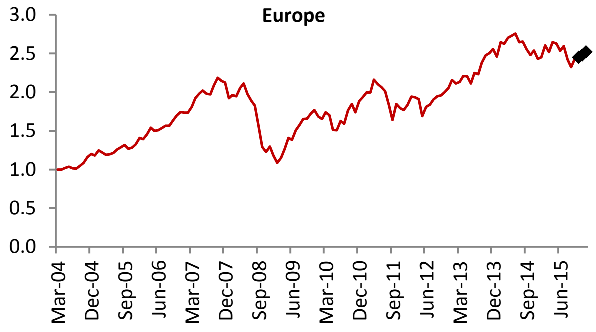
Source: Bloomberg

Cheap valuations by themselves are never enough to build a strong investment case, we would also like to see more fundamental reasons to be positive. For German equities we currently find plenty of reasons.

Accommodative central bank policy is an obvious support, one which we will not spend much time discussing as this is well understood by the market. All we will say is that it the ECB on Thursday officially threw the door to further QE wide open by stating that it was open to increasing the size, length and composition of its current monetary easing program and re-affirms the 'Draghi-put'.

However, the cornerstone of our positive outlook on Eurozone equities in aggregate relates to the likely trajectory of earnings growth. Equity markets will move up and down based on short-term news flow such as the ECB's positive message of support on Thursday. However, what drives markets on a more sustainable basis is earnings and earnings expectations.

Overall we expect significant scope for upside surprise on European and German earnings in the medium-term. Economic growth in the Eurozone is picking up, we have seen bank lending start to rise, wage growth remains subdued and interest costs are low (and potentially falling further). Coupled with the fact that earnings in the region are coming from a very low base (especially compared to the US and Japan) and consensus expectations are undemanding means that the potential for earnings growth and positive surprises is high. The below chart shows European real earnings over time with the black dots representing consensus expectations for 2015, 2016 and 2017. These numbers show that in 2017 the consensus expects European earnings to still be well below their previous peaks. For context, the same charts for the US and Japan shows the belief that earnings in those two regions will be approximately 30% above their previous peaks respectively. This means that the risk of a negative earnings shock is far lower in Europe than in the US or Japan.



Source: Reuters

In Q2 61% of European companies beat EPS expectations vs a long-term average of 48% according to Thomson Reuters Datastream. And although these are early days in the Q3 earnings season, European companies are off to a good start, with 83% of companies reporting EPS beats so far.

Overall we believe that following the market correction that the top-down and bottom-up factors have aligned for German equities which we think will allow the market (and European equities more broadly) to enjoy a period of sustained strong performance.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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