Brompton Insights

November 2021

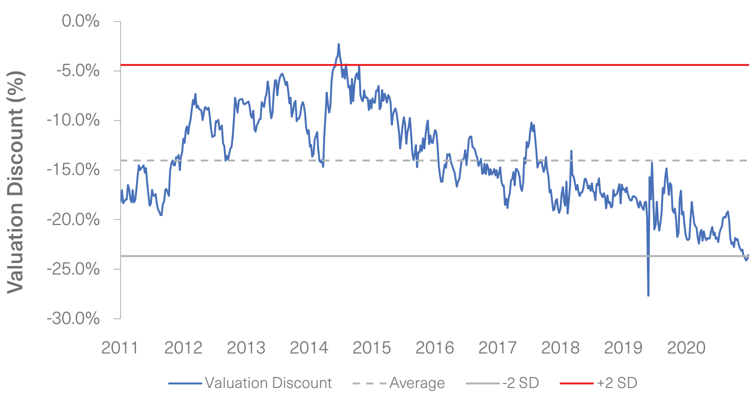
A New Voyage in the Old Continent

Fund in focus: Brompton European Dividend Growth ETF (EDGF)

The European market has long been underappreciated and underinvested by North American investors due to their perceptions that Europe lacks growth and innovation. However, the narrative has shifted: STOXX 600 realized a total return above 20% YTD, keeping pace with the S&P 500 and outperforming other major indices in the developed markets such as Japan's TOPIX and Australia's ASX 200. Both the macro backdrop and corporate fundamentals in the region have become increasingly supportive, thanks to effective vaccination programs and progressive fiscal stimulus. We believe European equities will continue to shine, offering more attractive risk-reward profiles than other major equity markets.

European equities have historically traded at a discount relative to U.S. equities, and recently the valuation discount has widened to ~25%, two standard deviations below its 10-year average (Chart 1). Low valuations were accompanied by stellar corporate earnings for the first half of 2021, with many companies beating consensus and raising earnings outlook. This translated into elevated fund inflows to Europe over the past 12 months. On the other hand, valuations of the U.S. corporates are relatively more expensive. Despite different sector concentrations partially explaining the valuation gaps between Europe and the U.S., European equities still look less expensive on an equal weight basis (Chart 2).[1]

Chart 1: Europe Valuation Discount to the U.S.



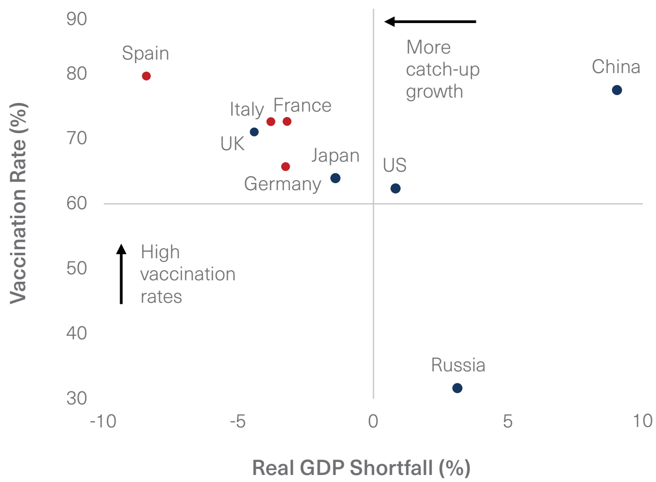
Source: Bloomberg (October 15, 2021)

Chart 2: 12-Month Forward P/E of MSCI Equal Weight Indices

Source: Bloomberg (October 23, 2021)

Shifts in fiscal mindset in the Euro Area since COVID-19 have been a turning point and will likely be a game-changer for the skeptics to reconsider investing in the old continent. The implementation of the EU Recovery Fund, which provides weaker economies with grants and long-term loans financed by common debt issuance, has proven to be a strong response to the pandemic. Aided by high vaccination rates, the Recovery Fund should continue to strengthen the catch-up growth for countries with large GDP shortfalls over the next 5 years, notably Spain (Chart 3).[1] Furthermore, newly issued debt will become important pillars of European banks' assets, diversifying their sovereign debt portfolios. Politically, waves of Union-wide fiscal stimuli will push countries in the direction of further integration, helping alleviate the long-lasting pain due to a lack of risk-sharing among the EU members. The recent German election, regardless of outcome, should further solidify this fiscal shift, which means less fiscal hawkishness and more public investments.

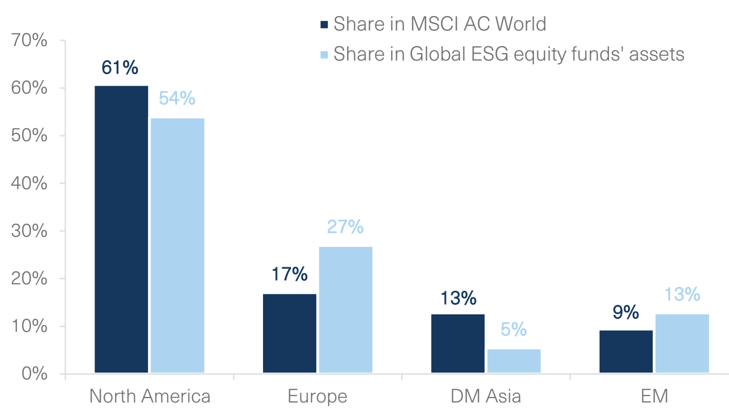
Chart 3: Vaccination Rates are High in European Economies



Source: Goldman Sachs (October 15, 2021)

Europe is also the global leader of ESG and sustainability, where companies enjoy higher scores on various ESG metrics than those in other continents. Europe continues to dominate ESG-related assets under management in terms of both new fund launches and annual net inflow.[2] We believe fund flow into ESG mandates will continue to favor Europe. Despite making up only 17% of the global equity market cap, European equities contribute to 27% of global ESG equity fund assets, proportionally outpacing other major economies (Chart 4).[3] Fiscal and political forces also emphasize sustainability—climate change initiatives must account for at least 37% of the expenditure for countries approved for the Recovery Fund.

Chart 4: European Equities Leaders in ESG



Source: Goldman Sachs (July 2, 2021)

Back in 2000, the top 10 largest cap STOXX 600 companies were concentrated in the communications and energy sectors. Fewer companies in these sectors were on the list 10 years ago, and today there is not a single energy or communication. Technology, consumer, and pharmaceutical companies have taken over as the largest European companies by market capitalization, offering stronger innovation and growth. Sector and company diversification within Europe continues to evolve, providing North American investors with the opportunity to enhance overall portfolio diversification.

Brompton's Approach

Brompton European Dividend Growth ETF ("EDGF") focuses on European companies that are leaders in their respective segments. Their leadership positions allow them to remain resilient in times of uncertainty and their operational scale drives strong economics.

[1] Goldman Sachs, Top of Mind: Europe at a Crossroads, October 15, 2021. Note: GDP shortfall reflects 2Q21 real GDP level relative to 4Q19; vaccination rate refers to share of total population with one dose.

[2] Credit Suisse, What ESG Investors Buy and Sell, July 22, 2021.

[3] Goldman Sachs, ESG: Keep Pushing, July 2, 2021.

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