Question: Should I still own European equities?
Answer: We are sticking with our call that the European economy will improve and that cheap European equities offer substantial upside for patient long-term investors.

- There has been plenty of bad economic news out of Europe, they have many structural economic issues that need to be addressed with reforms, and their high levels of debt remain a concern. However, there are reasons for optimism and we list some of them below.
- Euro area growth and inflation are tightly tied to bank lending to firms and households. The recently launched bond buying program by the ECB and this coming Sunday’s release of the bank stress tests should greatly improve the availability of credit to the private sector. The figures below show the tight credit conditions that have existed since the Great Recession which should ease as a result of the ECB actions.

- Fiscal drag (higher taxes and lower government spending) in the Eurozone averaged 3.4% of GDP from 2010 through 2013. This falls to 0.7% from 2013 through 2016, removing a huge economic headwind.
- Government borrowing costs have been greatly reduced for all European countries with Spain’s 10-year note at 2.2% and Italy’s at 2.5% (compared to the U.S. at 2.2%).
- The weaker Euro will help European exports.
- Lower energy costs will help European consumers and most businesses.
- There is also significant pent-up demand for both consumer goods and corporate capital expenditures.
- European stocks are relatively cheap with a forward PE of 13.9 compared to the S&P 500 at 15.3. This is on depressed earnings estimates that are still 20% below the ‘07/’08 peak compared to the S&P 500 which is 27% above the ‘07/’08 peak.
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