Crossbow Partners
Experience & Discipline

London Trip Report

After the Election ….Is before the Brexit Negotiations

June 19 - 20, 2017

Executive Summary

Investing in U.K. stocks predicated on the domestic economy becomes increasingly challenging, as the outcome of the Brexit negotiations is at best a sluggish economy and at worst an outright recession in 2019

In Europe, the outlook for electricity is fast improving and we could see further tightening of power prices in 2018, as we have crossed the trough in the 10 year downcycle that renewables created

There is a fair chance that some European countries - under the leadership of France - will introduce a carbon price floor to support the coal phase-out, but also to discreetly subsidize their ailing utilities

Equity managers are still constructive on European equities, but they have turned more cautious after the strong rally since the French elections and become much more selective in terms of sector preference and factor risk (small caps)

European equity markets will benefit from slow, but steady GDP growth, low interest rates, and an improving jobs and earnings picture, while the stronger EUR may have a dampening effect on sales growth (exports) as well as on competitive positioning

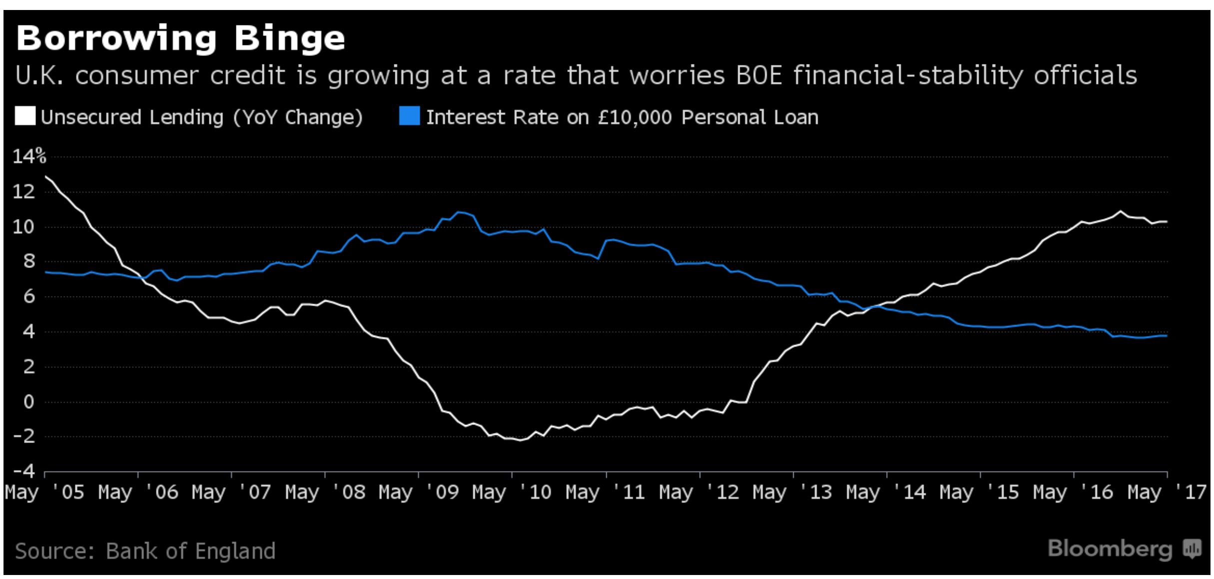
Financials have reached a tipping point in Europe, as asset prices have started to rise again, while banks have made enough provisions to deal with NPLs and to replenish their capital base

While the solvency crisis in Europe may be behind us after the substantial recapitalization of large European banks, the profitability crisis is far from over and financials should exhibit considerable upside potential from here

Macro and Equity View

1. Fallout from the elections and from Brexit

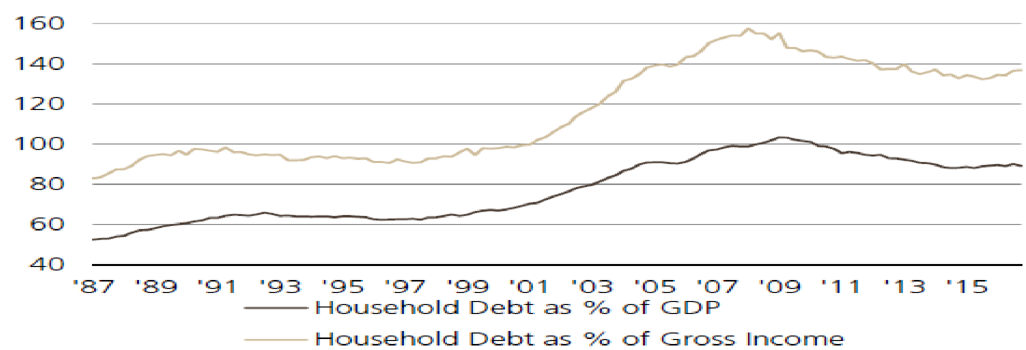
June will go down in history as another memorable turning point: Theresa May's election gamble backfired badly, leaving the Tory party in disarray. The Conservatives lost their parliamentary majority in a snap election that they had called when they were 20 percentage points ahead in the polls. While the PM was counting on a feeble voter turnout to boost her chances of winning an absolute majority, the opposite happened and voter turnout rose to a 20-year high of almost 69%. As a result, the Conservatives now have to rely on the support of the DUP in a hung parliament, and a weakened British government is forced to conduct the Brexit negotiations from a perceived position of weakness.
At the same time, domestic economic data have stoked investors' concerns about the country and its divorce from the European Union. While the resilience of the U.K. economy following the Brexit referendum has been unexpected and remarkable, the most recent June manufacturing data raises doubt about the outlook, as the PMI data fell to a three-month low of 54.3 from 56.4 (revised) in May. The result adds to evidence that the inconclusive elections and the uncertainties surrounding the start of the Brexit talks are weighing on households and companies. The managers we met were puzzled by the question whether the expected slowdown in private consumption in 2H 2017 – driven by a weaker GBP, higher inflation and higher input costs, as well as rising mortgage rates – is temporary or structural. Most managers believe that household finances will come under pressure as higher inflation erodes both wage growth and consumers' purchasing power. At the same time, U.K. consumer credit in May continued to grow at a double-digit pace, as unsecured lending rose 10.3% over the year.



Source: Bloomberg, June 30, 2017

Consumer borrowing has not garnered headline news recently, as it accounts for just a fraction of household debt. Yet, it has now emerged as a cause for concern among policymakers, as the guardians of financial stability in the U.K. have warned that debtors are more likely to default on their unsecured loans than on their mortgages. Of particular concern is car lending which has grown about 20% p.a. and borrowing on credit cards which has risen an annual 9.1% in May. The BOE has addressed the rapid buildup of credit by ordering lenders to set aside billions of pounds of extra capital in case the economy rolls over and customers cannot pay back their debts. With rising inflation eating into the purchasing power of consumers, there are concerns that people turning to easy money to help finance their spending may struggle to keep up with their debt payments if interest rates increase.

Fig. 2: Levels of household debt have fallen, but remain high in an historical context
Household debt ratios



Source: ONS, UBS, as of June 2017

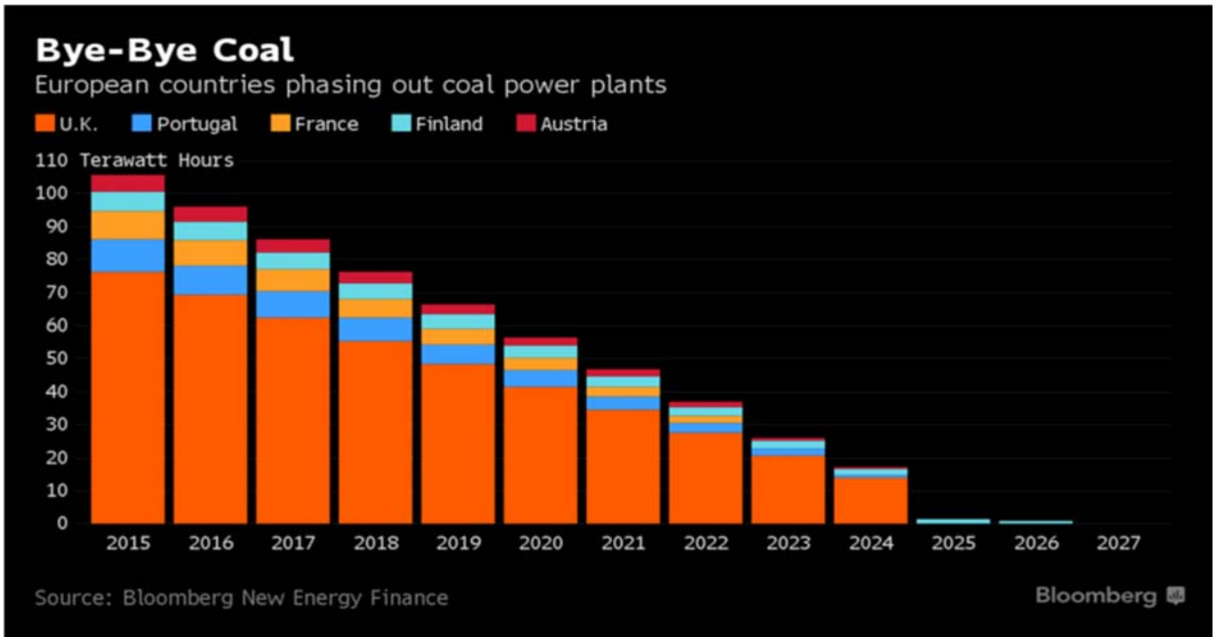
It is important to understand whether household finances are likely to come under pressure or not, as the remarkable resilience of the U.K. economy after last year's Brexit vote can partly be explained by the strength of household spending. Whether consumer spending will roll over or not is crucial to the outlook of the U.K. economy and sterling assets. Some of our managers contend that the U.K. is fast becoming one of global investors' least favourite places to put money, as some risk factors such as stalling (or falling) consumption, weaker asset prices (housing market), higher inflation, rising debt levels, a weakening GBP, and the uncertainties surrounding Brexit talks are increasingly weighing on investor sentiment.

2. Investment themes

Investing in U.K. domestic situations becomes increasingly challenging, as the outcome of the Brexit negotiations is at best a sluggish economy and at worst a recession in 2019. Some managers therefore believe that U.K. equities will go through a difficult period over the next few years, specifically stocks that are related to the retail side. They consider these sectors in a structural decline and believe margins will be squeezed by higher input costs (inflation) due to a weaker GBP, while wage growth and asset prices looks set to remain depressed and banks are curbing their unsecured lending activities. The transfer of well-paid jobs to the Continent in the wake of the Brexit negotiations has already begun and could further weaken consumption in the U.K. Managers in the cyclical camp maintain that inflation will peak in 3Q 2017 and purchasing power of consumers will recover accordingly. As this temporary slowdown in consumption is largely priced in, U.K. consumer-related stocks could surprise on the upside and see a nice bounce towards the end of the year.

Our commodity managers continue to see significant downside to the US power market due to low gas prices and the rapid expansion of solar and wind, leading to oversupplies in some regional markets such as Texas (where, incidentally, in the past more coal has been consumed than in any other area of the U.S).

In Europe, however, the outlook for electricity is far more constructive. The managers believe that we have crossed the trough in the 10 year downcycle of power that renewables created. The closure of coal in Europe has been significant over the last few years and it is now accelerating. Coal's use is falling by about 1% a year in Europe but still generates a quarter of the continent's power – and a fifth of its greenhouse gas emissions. If Europe let the 300 coal plants run to the end of their natural lifespans, the EU nations will exceed their carbon budget for coal by 85%. The EU will therefore have to stop using coal for electricity generation by 2030 if it intends to meet the goals of the Paris Climate Agreement. And it begins to dawn on the owners of coal plants that they cannot run these entities at competitive costs in the long run as renewables become more ever more affordable.



Source: Bloomberg, April 19, 2017

According to Bloomberg, plant owners in Germany are waiting for approval to close 27 mainly older coal and gas plants with a capacity of 6.6 gigawatts, while in April RWE and Steag just shuttered two Voerde power plants with a capacity of 695 megawatts each, as the owners refused to operate the plants at a loss. In France, Engie sold or announced the closure of more than half of its 15 gigawatts of coal-fired power plants worldwide as part of a plan to exit the fuel by the end of 2018, while EdF announced the sale of its coal trading business. In Denmark, its biggest utility Dong Energy declared this year it will exit coal by 2023, eliminating a fuel that accounts for 46 percent of current power generation.

In the developed world, the phasing out of coal in electricity plants is likely to continue to tighten the power market. If we add to that the expected German nuclear capacity closures, investors may see significant upside to power prices starting next year. And, what is more, there is a decent probability that France (and some other European countries) might introduce a carbon price floor – as in the U.K. – to support the coal phase-out. The new President Macron has already reached out to Angela Merkel to establish a common price floor for carbon dioxide emitted by power plants. Merkel is unlikely to support such a plan before the German elections in September as it will hurt the large German utilities RWE and Uniper due to their heavy reliance on lignite and coal to produce electricity. For Macron, the introduction of a carbon price floor of 30 EUR per ton of CO_2 emission could turn out to be a smart move. A carbon price floor would put him in the position to discreetly subsidize the ailing French utilities EdF and Engie under the pretext of fighting for the Paris Climate Agreement, while, at the same time, addressing carbon emission reductions that greatly appeal to a large group of his voter base. Both EdF and Engie have lobbied hard in the past to introduce such a minimum floor price, arguing it would boost the use of natural gas-fired power stations – and, of course, their profitability. As particularly long-dated power contracts remain very cheap in Europe, one manager has started to build options positions in France and futures positions in Germany to capture the expected market moves.

While coal may be caught in a longer-term terminal downward spiral in Europe, it will remain the key fuel for power generation in emerging markets for many years to come. One manager believes that the price for European quality coal has now troughed. Coal is currently attractively priced, while trading at low volatility levels. It could be set up for a sharp rebound over the next 12 to 18 months, as demand for coal will pick up due to plant closures and continuous high demand for quality coal from emerging market countries.

Equity managers are still positive on European equities, but they have recently grown more cautious after the strong rally in the wake of the French elections. And on valuations grounds they have also become much more selective in terms of sector preferences and factor risk. Notably valuations of small caps have risen to lofty heights.

Europe Sector Discount/Premium to U.S. Peers

Sector	BEst P/E	Current Discount	5YR Average Discount
Telecom	16.22	18.48	6.33
Info Tech	20.70	13.99	24.39
Health Care	16.77	1.90	-0.08
Consumer Staples	19.93	-2.98	-1.27
Industrials	17.51	-6.42	-5.28
Financials	11.92	-12.66	-17.25
MSCI Europe Index	15.18	-16.21	-12.38
Materials	14.57	-18.32	-5.74
Utilities	14.45	-20.97	-17.96
Consumer Discretionary	13.07	-33.95	-26.16
Energy	14.34	-46.29	-35.90

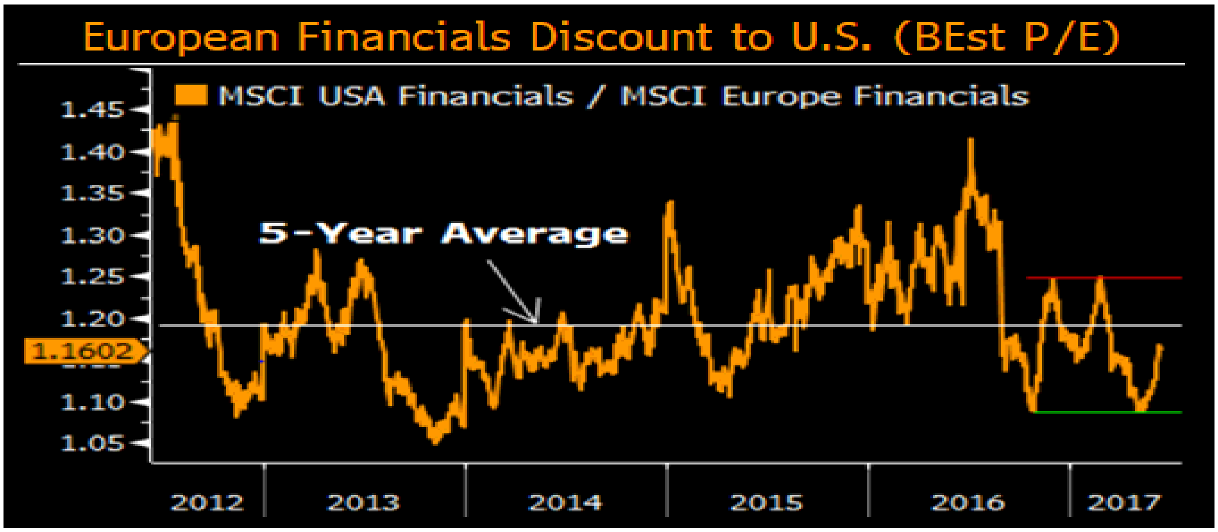
Bloomberg

Source: Bloomberg, June 21, 2017

European equity markets will likely continue to benefit from slow but steady GDP growth and an improving earnings and jobs picture. But the Euro has rallied more than 5% off its low, which can be a dampening factor for sales growth as well as competitive positioning. Nonetheless, the overall picture for Europe remains solid. The clear Macron victory in France is seen as a positive factor for France and the European markets. Investors are reassured that the wave of anti-establishment sentiment sweeping across the U.K. and the U.S. last year has petered out - at least for now. And many expect Angela Merkel now to be among the winners of the German election in September and thus to remain in office for another term. Improving earnings combined with subdued political risks saw therefore European equities fly in 1H. And they also remain cheap relative to the U.S. According to Bloomberg, European stocks still trade at a 16% forward P/E discount to U.S. equities in

June, well below the historical averages of five and ten years. In addition to that, Europe's expected dividend yield is 140bps above the U.S. And this may strongly appeal to yield-hungry investors on both sides of the Atlantic.

Not all sectors in Europe trade at a discount to their U.S. peers, but financials is one area where still a persistent discount of about 13% is available. While political risk is receding in emerging markets and in Europe, it is rising in the Anglo-Saxon nations due to Trump and the Brexit negotiations.



Source: Bloomberg, June 21, 2017

One of our managers believes that financials have reached a tipping point in Europe. Asset prices have started to rise again, while banks have made – or rather have been forced to make – enough provisions to deal with their NPLs and to replenish their capital base. Credit growth has recently picked up again across the Eurozone and if interest rates go up at one point and the yield curve steepens, this will be very beneficial for banks with their high operational gearing. Negative interest rates have put further additional pressure on European bank profit levels. While it is unclear whether current regulations will be repealed, it seems likely that further regulatory tightening as part of Basel IV is no longer in the cards.

While the solvency crisis may be behind us after the recent massive recapitalizations of European banks (Deutsche Bank, Credit Suisse, Unicredit, Monte Paschi di Siena), the profitability crisis is far from being over and financials should exhibit considerable upside potential from here. Thus, managers are now largely positioned to benefit from higher profitability, higher dividends, rising asset prices and accelerating growth in Europe and in emerging markets - and from falling asset prices in the UK (notably real estate).