FEG INSIGHT

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NAVIGATING UNEXPECTED TURBULENCE CAN BRING UNANTICIPATED REWARD

A View of Europe

FEG investment advisors

While traveling to Monaco is an exciting opportunity, severe flight turbulence is not.

"Mountain waves" are defined as oscillations to the lee side (downwind) of high ground, resulting from the disturbance in horizontal airflow caused by the high ground.[1] In layman's terms, wind hits a high mountain, causing a ripple effect and potentially severe turbulence extending as far as 50 miles from large mountain ranges.

This phenomenon might be bearable for the well-prepared locals who understand the complexities of mountain air travel and handle the turbulence well, but few on our flight enjoyed the trip over the Alps from Zurich, Switzerland to Nice, France. Our stomachs curled and nerves spiked with every wave the plane surfed, and a whimper escaped from one colleague's mouth.[2]

Similar to the flight to Nice, the European investment landscape also may offer some exciting opportunities, but not without some turbulence along the way. Understandably, locals with deep knowledge of the complexities of Europe's economies and politics are much better equipped to navigate an uncertain environment than are investment analysts from the U.S.

Four analysts from FEG's equity and hedge fund teams recently spent a combined five weeks traveling to destinations in London, Geneva, Zurich, Monaco, and Prague. We spent time meeting with government officials, catching up with recommended managers, and conducting introductory meetings with new managers.

While our conversations spanned asset classes, certain themes tended to arise in most, if not all, meetings, including valuations, fundamentals, merger and acquisition (M&A) activity, and the political landscape.

Valuations

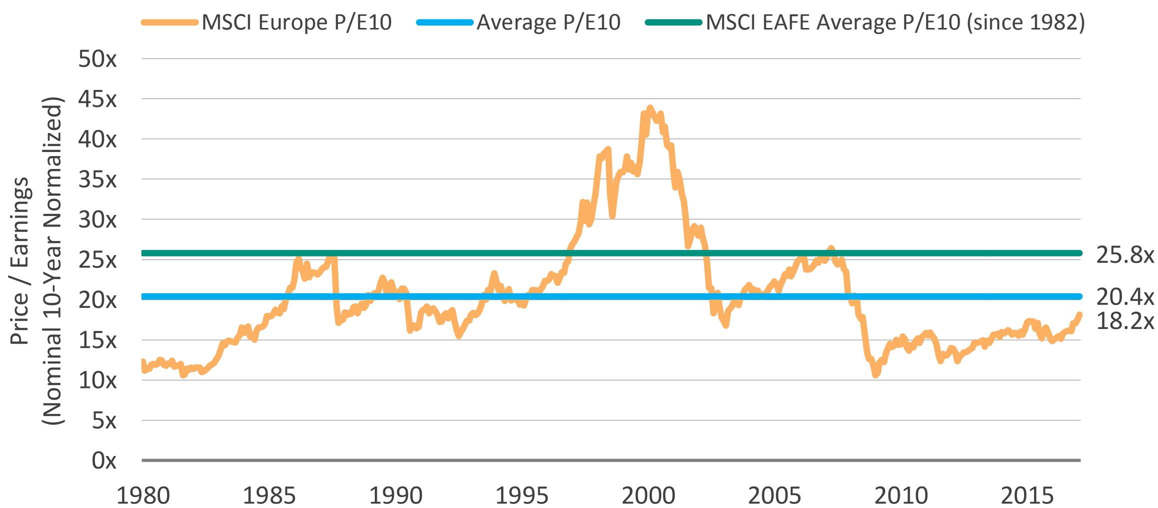
Dating back to the global financial crisis in 2008, European equities have been under pressure.

In 2008, the European banking system was in flux, a sovereign debt crisis was brewing, and corporate earnings were weak—all of which led to cheaper valuations in Europe than in many developed and emerging markets. Valuations have remained below average for many years and investment managers have taken notice. As illustrated in the chart, valuations based on cyclically-adjusted earnings have started to approach long-term averages, but the general sentiment throughout our trip was that value opportunities remain.

An attractive area of interest to the investment managers—despite an intense focus on European equities—was high-quality, global companies based in Europe. Many of these businesses had limited exposure to the European problems previously highlighted, but their stock prices sold off in sympathy with the markets of their country of domicile or listing. In some cases, revenues for these global businesses remained strong, or even improved, yet their stock prices sold off as investors sought to divest of anything European. Many of these stocks have languished, and with signs of positive momentum returning to Europe, active equity managers are beginning to focus on these high-quality, global businesses.

Banks and other financial companies have been among the cheapest stocks in Europe for several years following the global financial crisis and the European sovereign debt crisis. Many investors have broadly avoided the European banks due primarily to the poor quality and opaqueness of the businesses. However, we found that managers once again have started to highlight select opportunities within the financials sector. Banks are a debated opportunity, but non-bank financials that also offer low relative valuations are hitting the radars of managers and entering portfolios.

HISTORICAL VALUATIONS: INTERNATIONAL PRICE/10-YEAR NORMALIZED EARNINGS
MSCI Europe, 1980 – Present



Data source: MSCI

Part of our time in Europe was spent in Prague, meeting with a manager who highlighted value opportunities in emerging Europe. Investment managers have highlighted select opportunities in Russia, Hungary, Poland, and the Czech Republic where there are signs of fundamental improvement in addition to attractive valuations. Broadly speaking, opportunities within European emerging markets are more limited than those in developed European markets because Emerging Europe[3] is dominated by Russia, a country with questionable governance and a reliance on energy for its economic successes.

Cyclical businesses also were a focal point during our meetings. The expectations and signs of economic improvement in Europe are projected to provide a boost to businesses in cyclical sectors, such as industrials, energy, and materials. As investment managers see opportunity for economic improvement in Europe, cyclical companies that are more closely tied to the economy are believed to likely benefit the most. While there may be value in these areas, investors are then more greatly exposed to commodities. Falling commodity prices were a significant reason why stocks in these areas traded cheaply, therefore, stabilization and even appreciation in commodity prices may be required to unlock the value imbedded in these stocks.

Fundamentals

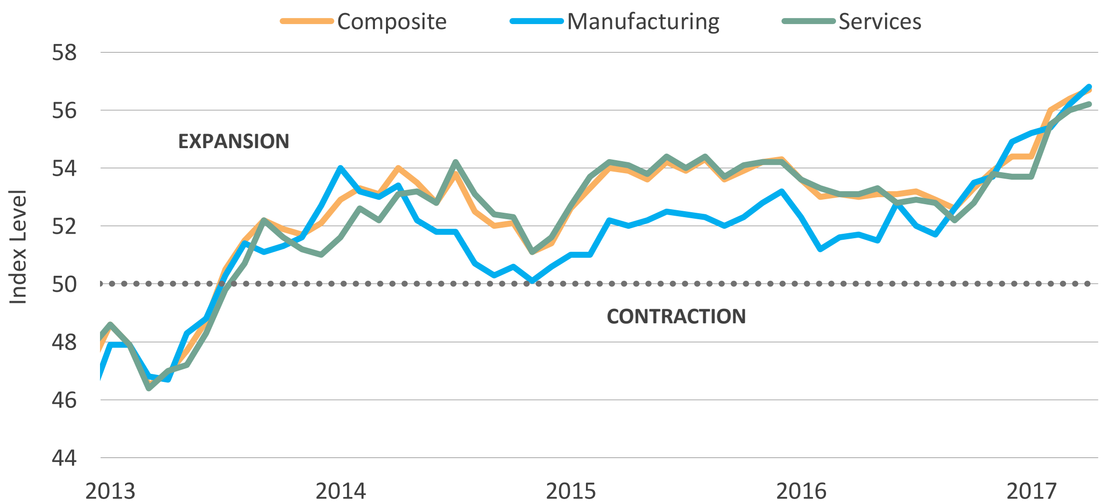
The European macroeconomic landscape continues to improve.

One comparison made by investment managers is that Europe today is like the United States in 2011, a time when the United States saw weak growth (1.6%), dealt with an exogenous shock (European sovereign debt crisis), and experienced rising discontent from parts of the population (Occupy Wall Street). Today, the European economy continues to experience meager growth, and is dealing with a refugee crisis and the rise of populism, which have led one country—the United Kingdom—to leave the European Union and several others to consider the same at the urging of political candidates.

A wise investor once said that you make the most money when things go from truly awful to merely bad, and that is where European investments find themselves today.[4]

Growth, as measured by GDP, was recently forecast at 1.7% by the European Commission—a significant improvement from previous years. Recent Purchasing Managers Index (PMI) readings from across Europe reached multi-year highs and point towards an increase in economic activity. For instance, France's composite PMI, a measure of economic sentiment, has increased nearly 10% in 2017. Germany's PMI has also ticked higher in 2017.

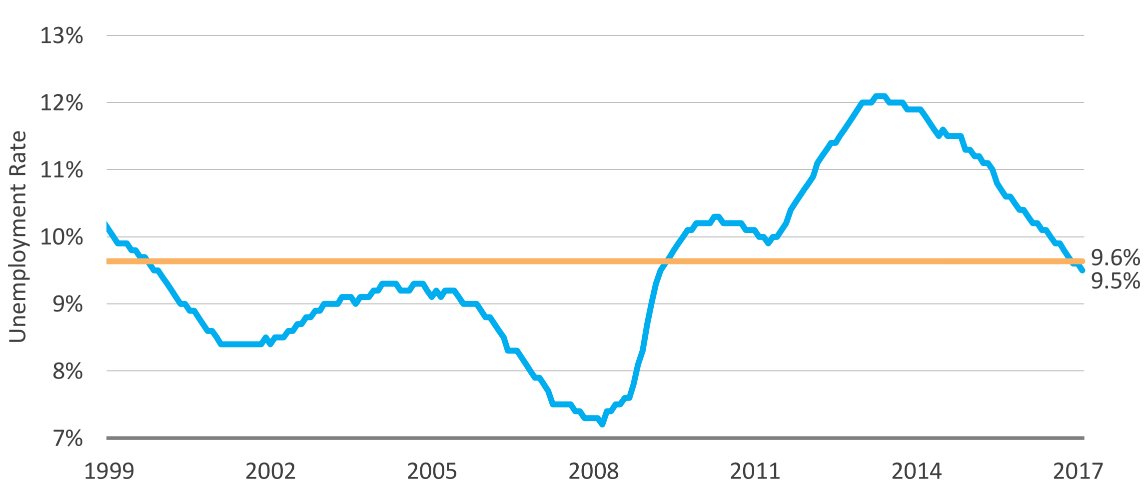
MARKET EURO ZONE PMI INDICIES



Data sources: Markit Partners, Bloomberg, L.P.; data as of March 2017

Similar to the United States in 2011, headline measures of unemployment have trended lower, albeit from a higher level overall. The headline unemployment rate recently ticked below the long run average, but is still above pre-Global Financial Crisis levels, implying potential for further fundamental improvement.

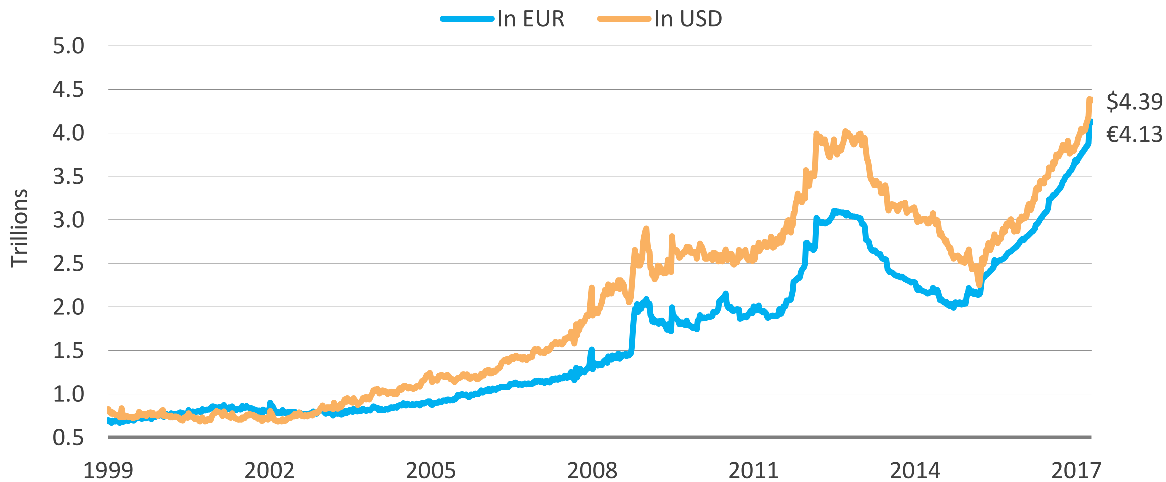
EURO ZONE UNEMPLOYMENT RATE



Data sources: Eurostat, Bloomberg, L.P.; data as of February 2017

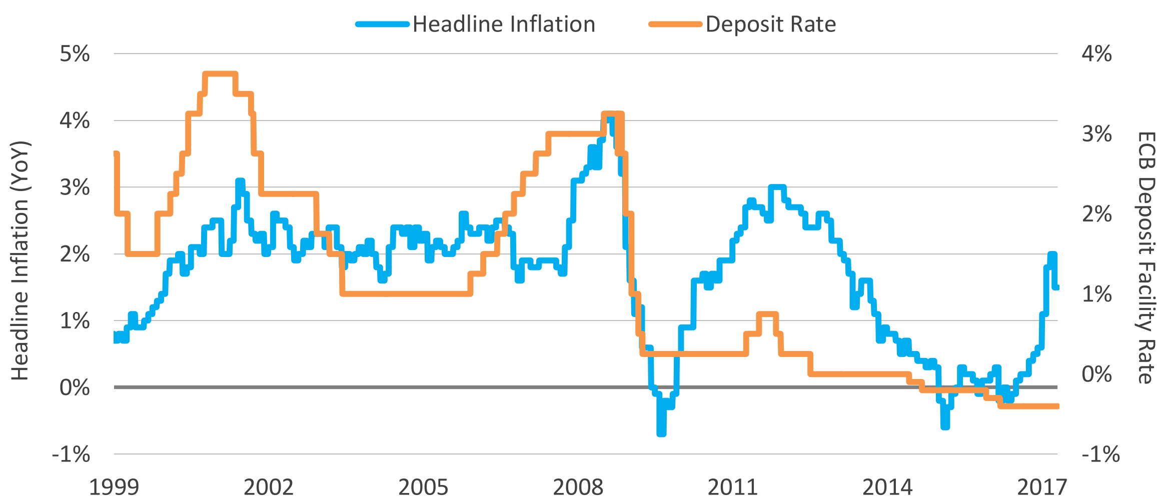
The European Central Bank (ECB) remains accommodative. The ECB elected to continue with its asset purchase program through the end of 2017, and will purchase €60 billion in bonds per month while inflation remains muted and below long-term targets.[5] This continued easing from the ECB could bode well for equity markets.

ECB BALANCE SHEET ASSETS



Data sources: European Central Bank, Bloomberg, L.P.; data as of April 14, 2017

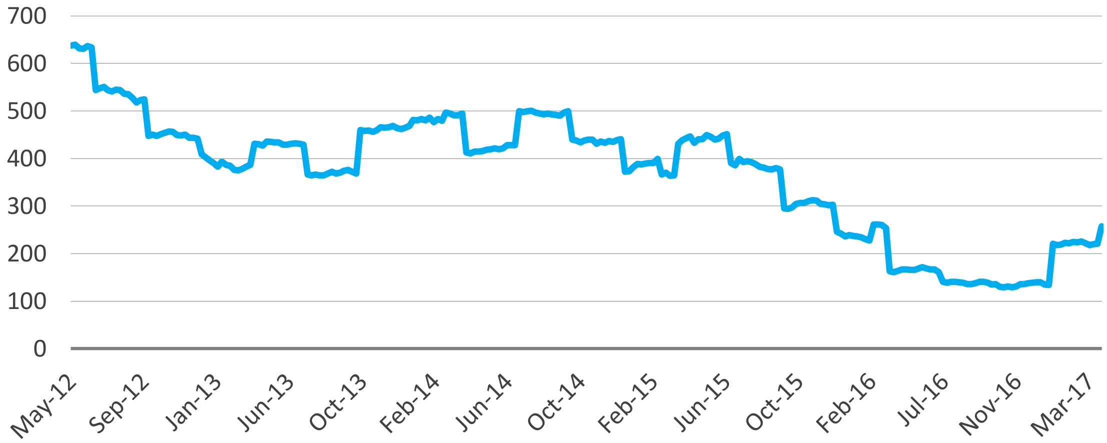
EURO ZONE INFLATION AND ECB DEPOSIT RATE



Data sources: European Central Bank, Bloomberg, L.P.; data as of April 21, 2017

One potential reason for the improving economic sentiment may be recent earnings growth. Although earnings per share of the FTSE 100 index have not recovered from their pre-crisis highs—and still have a way to go until they reach their previous peak—they have stopped falling and have started to recover in 2017. Given that earnings are the ultimate driver of equity market returns, this also could bode well for European equity markets.

FTSE 100 EARNINGS PER SHARE (EPS)



Data source: Bloomberg, L.P.

M&A Activity

The global financial market is generally conducive to corporate activity as CEO and board confidence is at elevated levels, cost of capital is cheap, and financing is widely available. Executives have been wrestling with an inability to generate organic growth, which has led to alternative growth plans such as mergers and acquisitions (M&A), asset sales and spin-offs, joint ventures, and strategic alliances, to name a few.[6]

Event-driven managers—funds employing strategies which seek to profit from corporate activity—are excited about the current global opportunity set. Corporate activity has ramped up in recent quarters, headlined by a robust M&A market, seemingly extending the M&A runway in what most believe to be late stages in the current cycle.

There was a discernable bit of optimism in nearly every meeting, as conversations inevitably led to a host of hard catalyst investment ideas within continental Europe. It has been years since European event managers expressed such a breadth of ideas unrelated to mega-deals involving a U.S. company.

Predictably, these investment professionals were reluctant to make macro forecasts, and they were deliberate in identifying the many risks which could derail the thesis. Still, the change in tone and subject matter discussed was significant.

A healthy first quarter of activity created a rather robust pipeline to begin 2017 and the majority of global and European-focused event managers FEG talked with anticipate the year to continue with elevated corporate activity. They anticipate tailwinds from a more accommodative U.S. administration, which often influences global regulatory regimes. One tangible reason several managers foresee a paradigm shift away from the intrusive nature of the previous administration is the current situation of the Federal Communications Commission (FCC). A new chairman was recently appointed, and once board vacancies are filled, the FCC is expected to implement new policies to reduce regulation and promote competition.

Barring a major geo-political event or a significant market shock, the global M&A market should continue to be strong for several quarters. While the M&A market generally takes its cue from the U.S., opportunities to exploit less-efficient markets in European situations are expected to be plentiful.

Many managers expect that an increase in European GDP growth combined with developing political clarity in the region will result in a release of pent-up M&A demand. Numerous fragmented industries exist across Europe, lagging the U.S. consolidation cycle. Many companies could be acquisition targets for large global brands, while other industries littered with regional players may combine, solidifying a reason to exist. Event-driven opportunities in Europe could be widespread and compelling, as less capital chases smaller, more complex, and less-followed situations.

Political Landscape

The relatively rosy picture for European risk assets in terms of valuations, fundamentals, and deal activity could face significant headwinds amid an uncertain political landscape across the euro zone. The French election passed without the shock effect of Brexit or the U.S. presidential election, with centrist Emmanuel Macron defeating far-right candidate Marine Le Pen in the May 7 runoff. To many investment managers, the French election was the most significant European political event entering 2017, as Le Pen's election would likely have signaled France's departure from the European Union (EU), and potentially led to the dissolution of the entire EU. While a "Frexit" may have been most detrimental to the future of the EU, investors are not out of the woods yet. Within the next 18 months there will be several presidential and legislative elections across developed Europe—including Germany, Italy, Norway, and Sweden—leading up to the March 2018 expiration of Britain's Article 50 negotiation period.

UPCOMING ELECTIONS IN EUROPE

Country	Timing
Germany Federal Elections	September 2017
Norway Presidential Elections	September 2017
Slovenia Presidential Elections	December 2017
Italy General Elections	May 2018

Source: FEG

UK Prime Minister, Theresa May, called for snap parliamentary elections to be held this upcoming June. May will seek a larger majority for her party, increasing her strength for Article 50 negotiations. Though a soft Brexit seems to be the consensus, several European-based managers expressed concerns that this increased influence could heighten the chances of a hard Brexit. May has been outspoken about her intentions in the Article 50 negotiations, stating, "We are not leaving the European Union only to give up control of immigration again. And we are not leaving only to return to the jurisdiction of the European Court of Justice."[7] The extreme case for a hard Brexit could result in the UK completely separating from the EU and failing to maintain relations with continental Europe, such as free trade and immigration.

Outside of Brexit negotiations, two presidential elections are at the forefront of investment managers' minds—Germany and Italy. Germany represents a much-larger share of the EU economy, making a potential German exit much more detrimental to European and global markets. However, Germany's reliance on exports makes such an event unlikely, and Angela Merkel appears to be headed to a fifth term. An Italian departure has some potential, at least according to recent manager comments. The Italian election, scheduled to take place between September 2017 and May 2018, will likely pit the Democratic Party's Matteo Renzi against the Five Star Movement's Luigi Di Maio. The two frontrunners have opposing views on how to recharge Italy's economy. Di Maio's plan would begin with a referendum on Italian EU membership, while Renzi would look to increase investment, clean up the banking system, and speed up judiciary processes.[8] Unfortunately, only time will tell.

Summary

Investing outside of one's home country can often be like a first-time flight over the Alps—bumpy and nerve-racking, with the occasional bout of turbulence. However, we believe a diversified investment portfolio that includes exposure to Europe may reward investors for withstanding the bumpiness and turbulence. Although several potential political headwinds still exist, European valuations are trading below historic levels, economic data and earnings have perked up, and the European Central Bank remains accommodative—all of which are positives for equity markets. Whether investing passively or with local managers to help navigate the "mountain waves," Europe's outlook may prove beneficial for those investors willing to allocate across the pond.

[1] Skybrary.
[2] Travelers included Michael Franke, Brian Hooper, Sean McChesney, and Stephen Thieme from FEG's equity and hedge fund teams.
[3] FEG uses MSCI's definition of emerging markets; Emerging Europe includes the Czech Republic, Greece, Hungary, Poland, Russia, and Turkey.
[4] Attributed to Arjun Divecha, Head of Emerging Equities Team, and Chairman, Grantham, Mayo, Van Otterloo & Co., LLC.
[5] Source: The Wall Street Journal. "ECB Holds Rates Steady, Leaves Stimulus Program Unchanged." January 19, 2017.
[6] Source: The Conference Board. "CEO Confidence at Highest Levels Since 2004." April 6, 2017. www.conference-board.org/data/ceoconfidence.cfm
[7] London Evening Standard
[8] Bloomberg

201 East Fifth Street
Suite 1600
Cincinnati, Ohio 45202

513.977.4400
information@feg.com
www.feg.com

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The Purchasing Managers' Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries, and the employment environment.

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