June 11, 2014

Europe

Strategy Matters

Portfolio Strategy Research

Getting leverage to ECB action

Following last week's ECB meeting, we look at the implications for the equity market of a period of both further credit easing and persistent low yields at the short end anchored by policy. In our view, some of the most advantaged segments of the market will be companies with high financial leverage, companies with good dividend yields and the ability to grow dividends and (depending on the conditions of the LTRO) the banks. We initiate a long recommendation on our financial leverage basket (GSSTFNLV) vs. the SXXP.

Credit spreads to narrow further...

Our Credit team argues that while more details of the ECB's targeted LTRO should come out over the next few weeks, the implications for credit are unambiguously constructive. We believe funding conditions are becoming persistently cheaper and that tail risks are diminished by the commitment.

...supporting financially levered stocks...

Companies with high financial leverage should benefit from narrowing credit spreads and the extra liquidity provided by the ECB. Given this, we initiate a long recommendation on our high financial leverage basket (GSSTFNLV) vs. the STOXX Europe. Our financial leverage basket trades on a 12m forward P/E of 16.0x vs. 14.5x for the STOXX, a premium of 10%. But this premium is not as high as in the recovery period in 2010. And based on FY3 earnings (2016), the basket trades slightly below its average rating to the market.

...and stocks with high yields and the ability to grow dividends

Our high dividend yield plus growth basket (GSSTHIDY) has done well as spreads have narrowed. We see the basket as an income proxy, but with the additional benefit that these companies have the ability to grow their dividends further. We continue to recommend the basket and see the ECB's action in easing credit and keeping rates anchored at low levels for the next few years as supportive.

Finally, both the banks and the market overall should benefit

The banks should also benefit from cheaper funding, although the details of the targeted LTRO will be important. We find that banks' performance is highly correlated with credit spreads and we remain overweight the sector. For the market overall, continued easy financial conditions underpin our case for a 'long grind higher' in equities. And further corporate bond yield declines should support companies' margins.

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Getting leverage to ECB action

Last week, the ECB announced a series of measures that aim to support credit growth in the Euro area. Our Credit team argues that while more details should come out over the next few weeks (especially with regard to the implementation of the targeted LTROs), the implications for corporate credit are unambiguously constructive – see *The Credit Trader, ECB actions boost our tactical view on European credit,* June 6, 2014. They argue that funding conditions are becoming persistently cheaper and that tail risks are diminished by this extra commitment by the ECB.

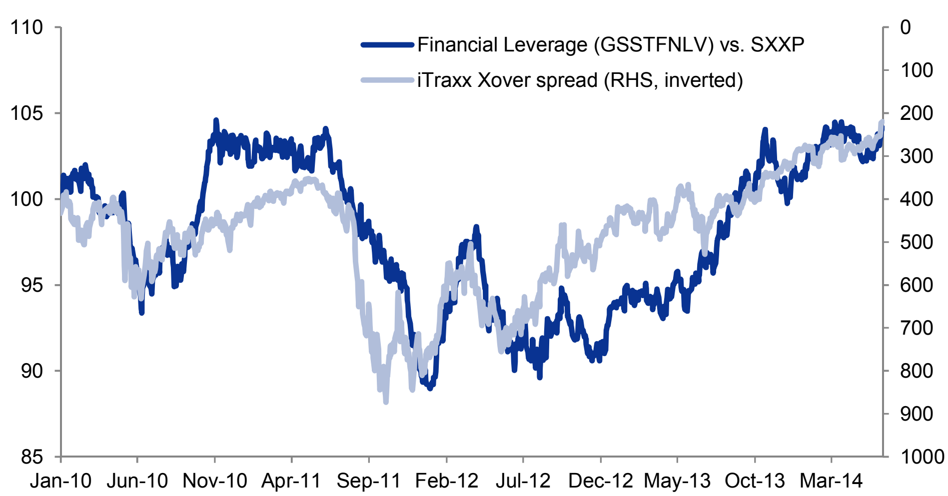
As we discussed in *Bold measures, but incremental easing*, June 6, 2014, we think the ECB's actions support our general stance on European equities, which is one where prices slowly grind higher supported by policy action and favourable valuations relative to other asset classes. In our view, some of the most advantaged segments of the market will be companies with high financial leverage and (depending on the conditions of the LTRO) the banks. In addition, the ECB's actions are likely to reinforce the search for yield, in our view. As a result, we also think that companies with good yields and the ability to grow their dividend should continue to do well and we continue to recommend our high dividend yield plus growth basket (GSSTHIDY).

Credit market impact and equities

Companies with higher-than-average financial leverage should benefit from narrowing credit spreads and the extra liquidity provided by the ECB; we initiate a long recommendation on our basket of stocks with high financial leverage (GSSTFNLV) versus the STOXX Europe (SXXP).

In our financial leverage basket, we screen for companies with 2014E and 2015E net debt/equity and net debt/market cap above 70th percentile, and interest cover below the median (based on Goldman Sachs' European coverage). This basket has been correlated with the performance of Xover Itraxx spreads. As spreads have narrowed since the summer of 2012, the basket has generally outperformed, although performance in the past six months has been more in line with the market. If spreads narrow further as economic growth improves, then we would see the stocks in this basket as generally well supported.

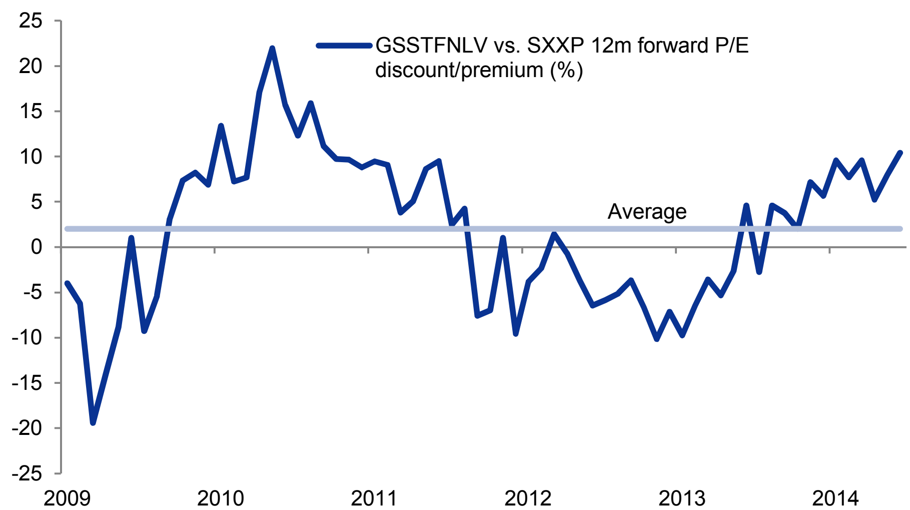
Exhibit 1: Companies with high financial leverage perform well as credit spreads narrow
Financial leverage relative price performance to the market indexed at 100 in January 2010



Source: Bloomberg, Goldman Sachs Global Investment Research.

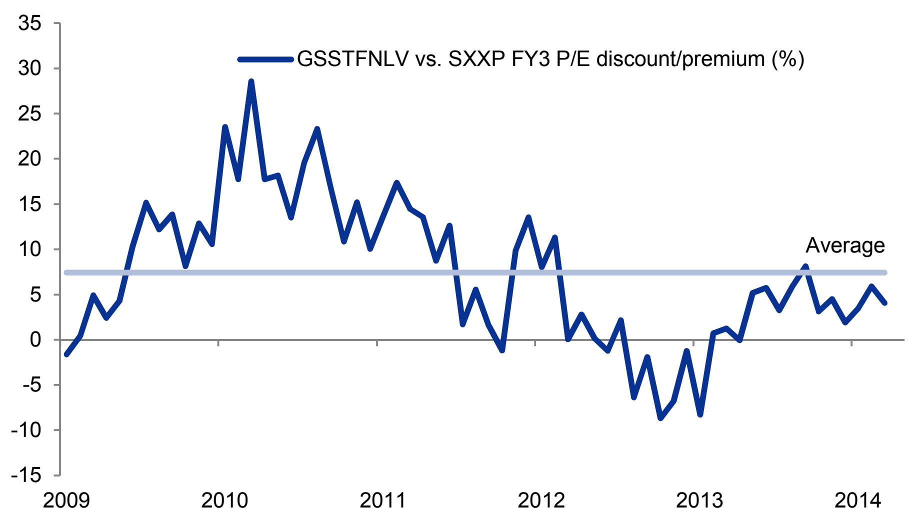
The financial leverage basket trades at a premium of 10% to the market based on I/B/E/S consensus 12m forward earnings – a P/E of 16.0x versus 14.5x for the STOXX Europe. But this premium is not as high as in the recovery period in 2010. And based on FY3 earnings (2016 currently), the basket trades slightly below its average rating to the market (Exhibit 3). We think that as growth improves and yields stay relatively low supported by the ECB's recent action, these stocks will outperform. We show the list of companies in this basket on page 10.

Exhibit 2: Companies with high financial leverage have re-rated...
GSSTFNLV: Financial leverage basket, SXXP: STOXX Europe



Source: I/B/E/S, Datastream, Goldman Sachs Global Investment Research.

Exhibit 3: ...but based on FY3 estimates the relative rating is not high…
GSSTFNLV: Financial leverage basket, SXXP: STOXX Europe



Source: I/B/E/S, Datastream, Goldman Sachs Global Investment Research.

Exhibit 4 summarizes valuation and growth metrics for the financial leverage basket relative to the market. While on a 12m forward P/E basis the basket is trading at a premium to the market, it offers higher earnings growth given the leverage of its constituents: over the next two years, the basket offers more than double the EPS growth of the market, with a larger increase in both sales and margins expected by the consensus.

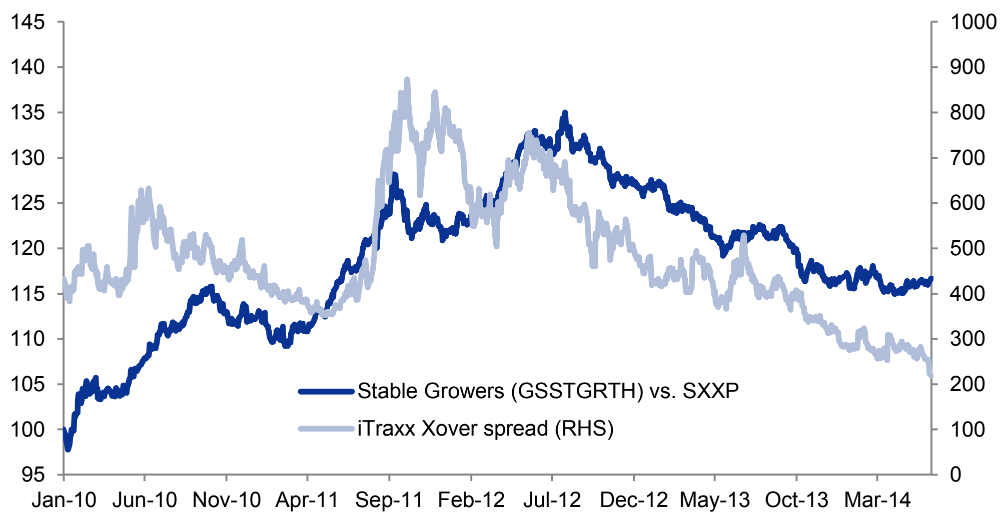
Exhibit 4: Valuation and growth metrics for our financial leverage basket and the market
GSSTFNLV: Financial leverage basket (NTM = next 12 months, LTM = last 12 months)

	GSSTFNLV	SXXP
EPS 13-15 CAGR (%)	19.0	9.2
Sales 13-15 CAGR (%)	4.0	1.8
14 Chg in profit margin (bp)	48	28
PE (NTM)	16.0	14.5
DY (%)	3.2	3.1
P/B (LTM)	2.3	1.8
Net debt/EBITDA (x)	3.0	1.6

Source: Factset, I/B/E/S, Goldman Sachs Global Investment Research

Meanwhile, companies with less rate-sensitive profiles tend to underperform when spreads are narrowing; for example, our stable grower basket (GSSTGRTH), where in each sector, we select companies with the highest average growth to standard deviation on growth and return metrics (net income growth, sales growth, ROE). The companies in this basket tend not to rely so much on debt financing, and more importantly strong historical performance has meant they have had sufficient cash flow to maintain growth without recourse to borrowing. In general, these companies are higher quality but more defensive and clearly not very sensitive to spreads contracting.

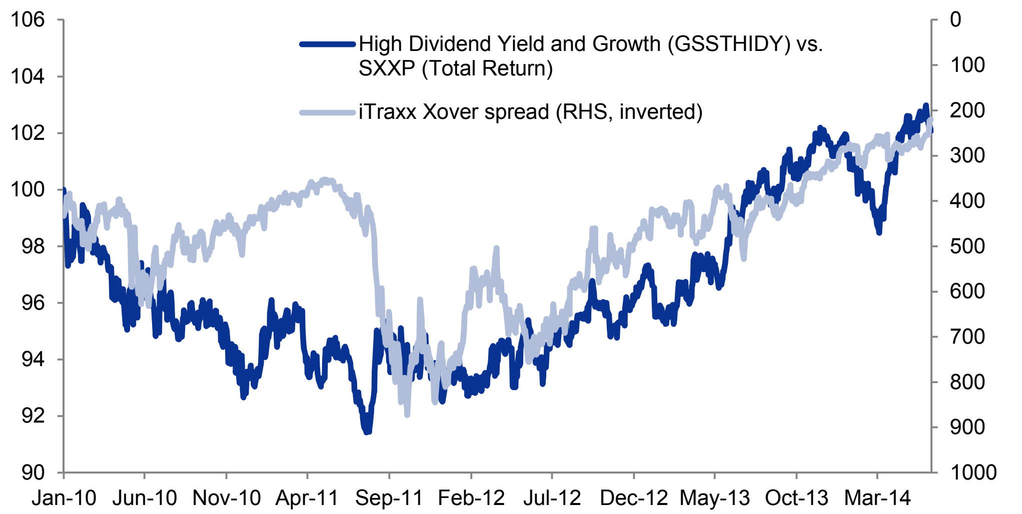
Exhibit 5: ...whereas stable growth stocks (GSSTGRTH) have underperformed
Stable grower relative price performance to the market indexed at 100 in January 2010



Source: Bloomberg, Goldman Sachs Global Investment Research.

Our high dividend yield plus growth basket (GSSTHIDY) has done well as spreads have narrowed. We see the basket as an income proxy, but with the additional benefit that these companies have the ability to further grow their dividends. We continue to recommend the basket and see the ECB's action in easing credit and keeping rates anchored at low levels for the next few years as supportive.

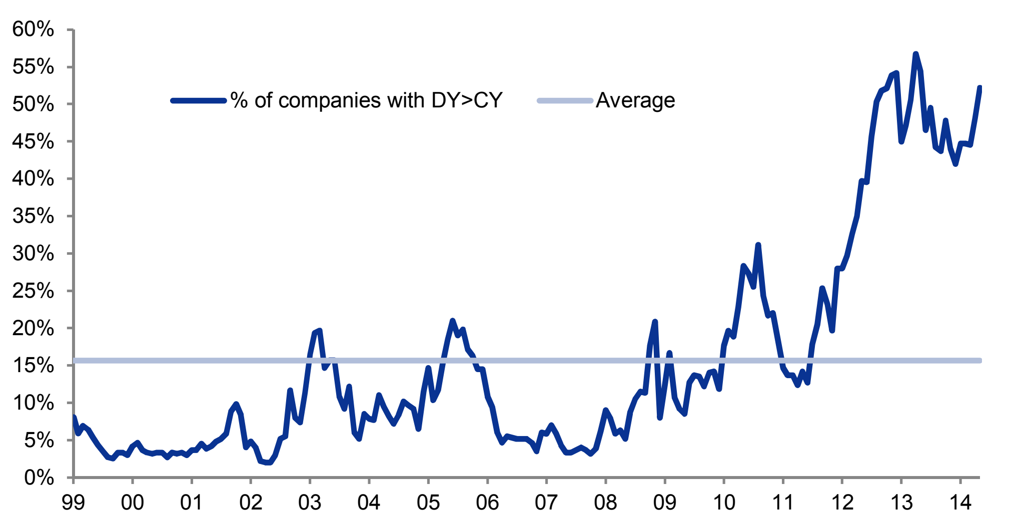
Exhibit 6: High dividend yield + growth strategy supported by narrowing spreads
High dividend yield plus growth basket (GSSTHIDY) relative total return to the market



Source: Bloomberg, Goldman Sachs Global Investment Research.

Indeed, taking the market more broadly, currently more than 50% of companies in the STOXX Europe index have a dividend yield above the yield on the corporate bond market (Exhibit 7). This proportion has risen above 50% again for the first time in a year, a function of the recent fall again in corporate bond yields.

Exhibit 7: Half of European stocks still have a yield above credit
% of companies with dividend yield above the Iboxx corporate bond yield

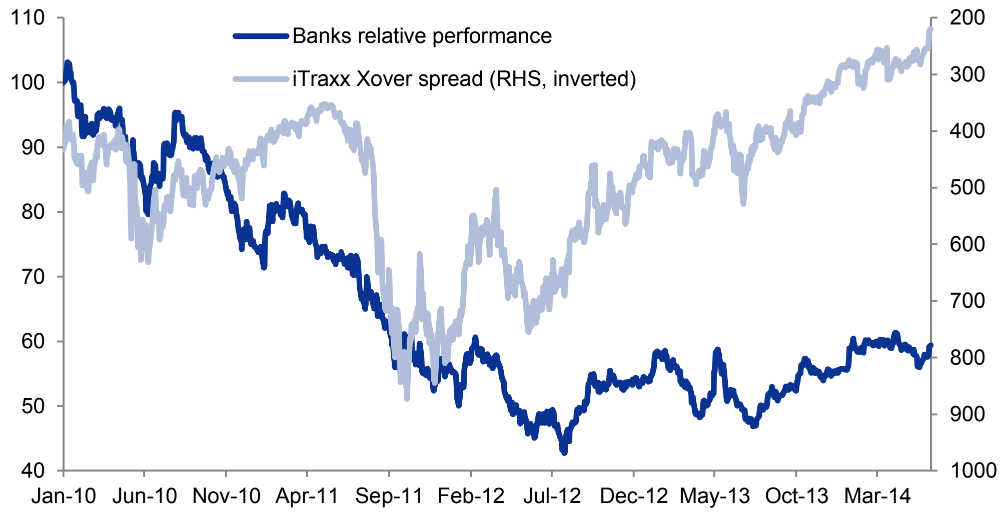


Source: Datastream, Goldman Sachs Global Investment Research.

Another area obviously exposed to any further spread compression is banks. For the banks, the details of the ECB's targeted LTRO will be important and we lack enough information to know how much of the offered liquidity they will be able or want to take up and under what terms the collateral requirements will be set. Moreover, some of any gain made on the lowered funding costs could be offset by lower net interest margins given the rate cut.

The conditions around this notwithstanding, the banks should benefit from cheaper funding guaranteed for the next four years, which they can use either to invest in carry trades (and in doing so push down yields), enhance their cash flow and/or strengthen their balance sheets over time. We find that banks' performance is also correlated with the Xover spread (see Exhibit 8).

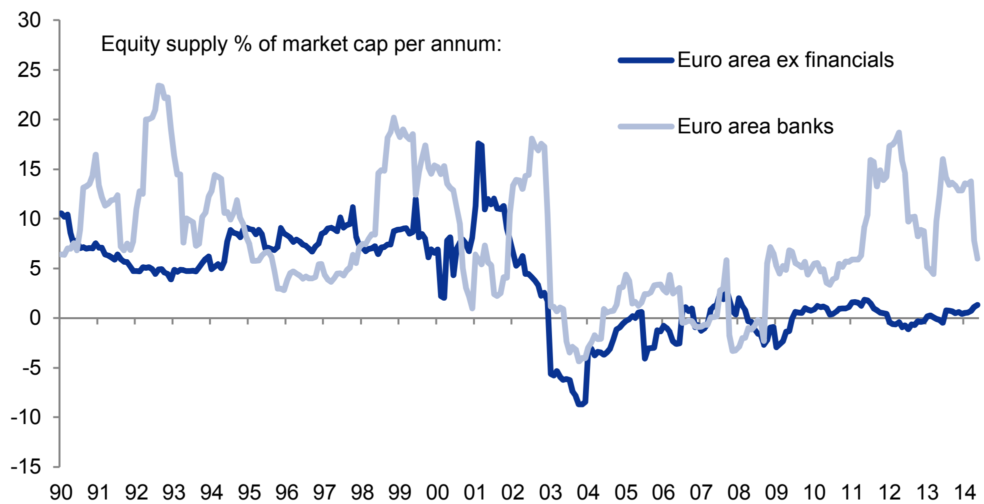
Exhibit 8: Banks' performance has lagged credit spreads tightening in Europe...
European banks' relative price performance indexed to 100 in January 2010



Source: Bloomberg, Datastream, Goldman Sachs Global Investment Research.

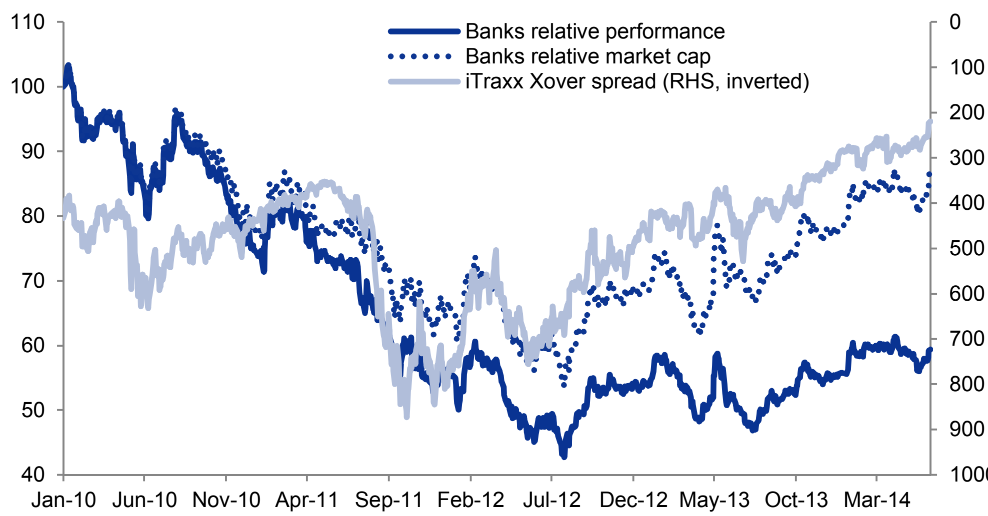
Performance in the past couple of years appears to lag behind what would have been expected given the narrowing in spreads. However, much of this could be because banks continue to rebuild balance sheets in many cases via new equity. Equity supply has been growing at about 5%-10% of market cap per annum for the sector over the past few years, whereas it has been almost flat for the market excluding financials (equity supply has been offset by some companies withdrawing equity) – see Exhibit 9. **If we compare the relative market cap performance of the banks with credit spreads, we see a close relationship. Again, this emphasizes the importance of support from the ECB both in terms of funding and enabling banks to rebuild capital positions. We remain overweight the banks sector given this support and what we see as reasonable valuation and gearing to economic improvement.**

Exhibit 9: ...but net equity supply has been high for the banks
Net equity supply as a % of market cap



Source: Datastream, Goldman Sachs Global Investment Research.

Exhibit 10: And in market value terms, relative performance has risen as spreads narrowed
Relative price and market cap performance to the European market

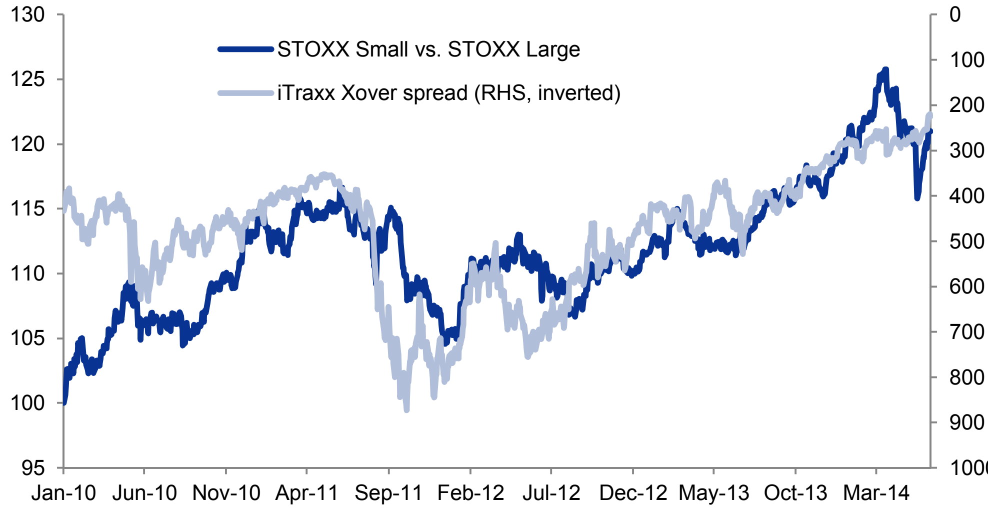


Source: Bloomberg, Datastream, Goldman Sachs Global Investment Research.

Small caps tend to outperform as credit spreads narrow

March and April saw a setback in small cap stocks, but this has proved relatively temporary. As shown in Exhibit 11, small caps tend to outperform as credit spreads narrow. Small caps are more sensitive to risk sentiment and tend to be more cyclical (there is less weight in very defensive sectors among smaller cap names). In addition, if credit conditions tighten, they suffer more than large cap stocks, which tend to have greater sources of funding available to them.

Exhibit 11: Small caps outperform as credit spreads narrow
Small vs. large cap relative price performance indexed to 100 in January 2010

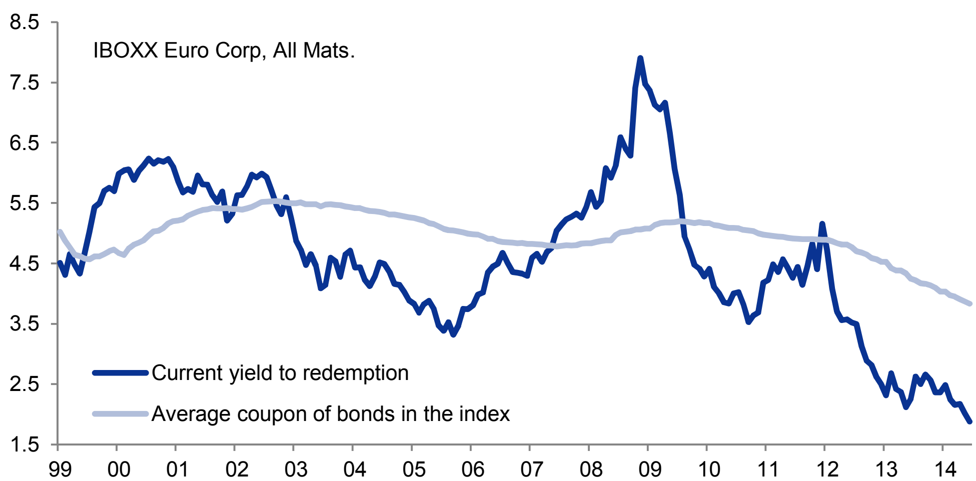


Source: Bloomberg, Datastream, Goldman Sachs Global investment Research.

Falling interest costs support margins, cash returns and M&A

More broadly, companies ought to continue to benefit from lower refinancing costs as they roll over existing debt – something that should support overall corporate margins for the market. Exhibit 12 shows that the current average coupon on Euro area-listed corporate debt is 3.8%, whereas the current yield to redemption on the corporate bond market is 190 bp below this. Assuming the companies rolling over debt or adding to debt have around the same credit rating as those already in the index, and banks' financing costs are evolving in a similar way to credit spreads, then we would expect a continued rolling benefit over the next few years from lower interest costs.

Exhibit 12: Refinancing costs very low relative to the current coupon on bonds
(%)



Source: Datastream, Goldman Sachs Global Investment Research.

Moreover, as we have discussed previously (see *Portfolio Strategy: Show me the money Part 1*, February 7, 2014, and *Part 2*, February 27, 2014), companies could also use this cheap funding, which is now increasingly underpinned by ECB action, to finance acquisitions or gear up their balance sheet and return equity to shareholders via buybacks. So far, though, companies have been cautious of doing this, and with high cash levels on their balance sheets they might not need to raise extra finance.

Impact of UK FLS: Too distorted

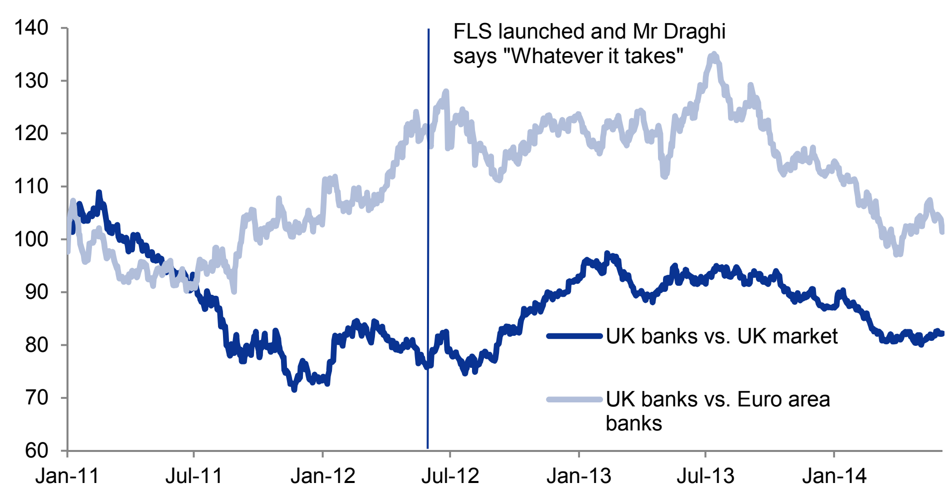
The UK Funding for Lending Scheme (FLS) announced in June 2012 by the BoE and HM Treasury to support UK bank lending provides one potential example of support for banks and encouragement to increase lending to the private sector. Our economists discussed the impact of this *in European Economics Analyst: ECB credit easing and the investment outlook,* June 5, 2014.

From August 2012, UK banks were able to refinance 5% of their loan book from the FLS facility, plus an amount equal to their increased (net) lending. Funding was available for up to four years. The fee charged depended on the increase in net lending, with the fee being higher for banks whose lending shrank.

Soon after the announcement of the FLS, UK bank funding costs fell significantly. Yet UK bank funding costs are highly correlated with Euro area banks' funding costs. As the FLS announcement coincided with Mr. Draghi's "whatever it takes" intervention in the summer of 2012, our economists argue it is difficult to disentangle the effect of the FLS policy from the effect of Mr. Draghi's announcement.

Overall, and alongside relatively weak UK net lending (especially to SMEs), the FLS effect is likely to have operated largely as an 'insurance policy'. As an insurance policy, its subsidy for lending was off balance sheet. Had Mr. Draghi not announced the OMT policy, UK bank funding costs would have been higher; the implied subsidy from the FLS – and FLS take-up – would then have been greater. Given Mr. Draghi's intervention, the 'insurance policy' view of the FLS supported lending by giving banks the confidence that funding costs would remain low. Even though banks' net lending to corporates remains negative in the UK, growth has picked up.

Exhibit 13: UK banks outperformed the UK market post the launch of the FLS
Indexed to 100 in January 2011



Source: Datastream, Goldman Sachs Global Investment Research.

UK banks outperformed the aggregate UK equity market in the year immediately after the FLS was launched. However, this probably had much to do with the reduction of tail risks in Europe as a result of Mr. Draghi's intervention. Nonetheless, UK banks' performance kept pace in relative terms with that of Euro area banks in the year post the FLS/Draghi announcements. Given the step-change in risk perception that benefited the Euro area banks post the summer of 2012, the fact that UK banks' performance kept pace with Euro area banks is perhaps evidence that the FLS was seen as a substantive support to the sector.

When lending does recover....benefit to domestic sectors & small caps

Our economists argue that while full details of the subsidy for term funding are currently unclear, it remains an open question whether the subsidy will be large enough to drive new credit expansion given weak demand from the corporate sector. In other words, they are sceptical that this will turn loan growth around anytime soon.

However, should these changes eventually provide a spur to lending growth, we would expect the more domestic-facing sectors in the equity market to benefit, as lending growth should drive investment and better economic performance in Europe. The table below shows correlations between Euro area operating profit growth by sector and growth in aggregate Euro area bank lending to the non-financial corporate sector.

Exhibit 14: Correlation of lending growth and operating profit growth
Year-on-year EBIT growth vs. year-on-year lending growth to the non fin. corp sector (from 1998)

Most & least correlated sector Op. profit growth with Euro area loan growth to corporates			
Most correlated sectors:		Least correlated sectors:	
Con & Mat	0.55	Insurance	-0.18
Banks	0.55	Food & Bev	-0.12
Utilities	0.50	Technology	-0.09
Oil & Gas	0.40	Financial Svs	-0.03
Inds Gds & Svs	0.37	Telecom	-0.01
Health Care	0.29	Travel & Leis	0.08
Basic Resource	0.22	Auto & Parts	0.08
Media	0.19	Retail	0.13
Chemicals	0.17	Pers & H/H Gds	0.15
Real Estate	0.17		

Source: Datastream, Worldscope, Goldman Sachs Global Investment Research.

The results should be treated cautiously, not least because the details of the LTRO and the impact on lending growth are unclear. In addition, the correlations are not that high for many sectors and the timing of a turn in lending growth and its potential impact on company profits are uncertain. Indeed, there is a relatively high correlation between Euro area lending growth and oil sector earnings – one that we think is most likely spurious or coincidental – as oil prices dipped sharply in 2008 just as lending growth dipped.

However, the general pattern we observe of more domestic-facing sectors having a positive correlation (construction, banks, utilities) and more defensive or international sectors having a low correlation (food & beverages and technology) seems intuitive. In addition, we find that small cap earnings are 68% correlated with lending growth, whereas large cap earnings are 49% correlated; so on balance, small caps should be greater beneficiaries if and when lending does recover.

Appendix: Financial leverage basket (GSSTFNLV)

Exhibit 15: Constituents of financial leverage basket (GSSTFNLV)
Criteria: Companies with 2014E and 2015E net debt/equity and net debt/market cap above the 70th percentile, and interest cover below the median (based on GS European coverage).

FINANCIAL LEVERAGE BASKET (GSSTFNLV)								
Company name	Basket weights (%)	Current market cap (€Bn)	Net debt/equity 14E	Net debt/equity 15E	Interest cover 14E	Interest cover 15E	Net debt/market cap 14E	Net debt/market cap 15E
Automobiles & Parts	**3.3%**							
Faurecia	3.3%	3.9	76%	52%	4.1	5.5	37%	31%
Basic Resources	**3.3%**							
Stora Enso	3.3%	7.5	52%	50%	1.7	2.3	47%	48%
Chemicals	**3.3%**							
Lanxess AG	3.3%	4.2	82%	64%	3.4	4.9	34%	28%
Construction & Materials	**13.3%**							
Vinci	3.3%	31.4	88%	75%	6.1	6.8	43%	39%
ACS	3.3%	10.7	62%	55%	1.6	1.7	46%	45%
Eiffage	3.3%	5.0	388%	341%	1.8	2.0	255%	247%
BAM Groep	3.3%	1.0	82%	79%	1.7	2.5	70%	67%
Food & Beverage	**6.7%**							
Heineken	3.3%	29.7	70%	73%	6.3	6.9	35%	40%
Pernod Ricard	3.3%	23.3	66%	65%	5.6	6.8	31%	33%
Health Care	**6.7%**							
Fresenius Medical Care	3.3%	14.3	69%	66%	5.3	6.0	39%	39%
Fresenius SE & Co KGaA	3.3%	19.8	83%	74%	4.9	5.7	66%	65%
Industrial Goods & Services	**23.3%**							
Gerresheimer AG	3.3%	1.6	71%	67%	4.0	3.8	28%	30%
G4S Plc	3.3%	4.8	174%	173%	2.5	2.9	43%	44%
Fraport AG	3.3%	5.1	111%	100%	3.9	4.5	54%	52%
ThyssenKrupp	3.3%	11.2	82%	72%	1.6	2.1	27%	27%
Atlantia	3.3%	17.6	161%	153%	2.4	2.6	60%	60%
Royal Vopak	3.3%	4.8	87%	76%	3.6	3.9	38%	37%
Smurfit Kappa Group	3.3%	4.1	90%	85%	2.5	2.9	60%	61%
Media	**3.3%**							
Eutelsat Communications	3.3%	5.5	190%	232%	4.9	5.0	63%	73%
Oil & Gas	**3.3%**							
SeaDrill Ltd	3.3%	13.4	182%	199%	4.7	4.8	83%	95%
Personal & Household Goods	**3.3%**							
Imperial Tobacco	3.3%	31.6	186%	189%	6.1	6.4	37%	36%
Retail	**6.7%**							
Metro	3.3%	10.1	61%	55%	2.8	2.9	39%	36%
Dufry	3.3%	3.5	129%	106%	3.9	4.4	38%	37%
Technology	**3.3%**							
Alcatel-Lucent	3.3%	6.7	63%	99%	1.5	1.7	24%	29%
Telecommunications	**16.7%**							
Telefonica	3.3%	57.7	156%	146%	2.7	2.9	71%	67%
TDC A/S	3.3%	5.8	103%	97%	3.6	3.8	48%	46%
Inmarsat Plc	3.3%	4.4	176%	159%	4.0	4.5	34%	31%
Royal KPN NV	3.3%	11.7	682%	526%	1.7	1.8	93%	88%
Belgacom	3.3%	7.9	73%	76%	7.0	6.1	26%	27%
Utilities	**3.3%**							
Suez Environnement	3.3%	7.9	113%	122%	2.8	3.0	95%	103%
Median		**7.7**	**87%**	**82%**	**3.58**	**3.86**	**43%**	**42%**

Source: Datastream, Worldscope, Goldman Sachs Global Investment Research.

Exhibit 16: Sector and country weight of financial leverage basket (GSSTFNLV) relative to the market (SXXP)

	Financial Leverage (GSSTFNLV)	Stoxx Europe 600 (SXXP)	Diff. in sector weight
Ind. Goods & Srvs	23.3	10.9	12.4
Telecom	16.7	4.4	12.3
Constr. & Mat.	13.3	2.5	10.8
Retail	6.7	3.0	3.7
Media	3.3	2.5	0.8
Technology	3.3	3.1	0.2
Auto	3.3	3.2	0.1
Basic Resources	3.3	3.2	0.1
Utilities	3.3	4.4	-1.1
Food & Beverage	6.7	8.0	-1.3
Real Estate		1.4	-1.4
Travel & Leisure		1.6	-1.6
Financial Services		1.6	-1.6
Chemicals	3.3	5.0	-1.7
PHHG	3.3	5.6	-2.3
Health Care	6.7	11.5	-4.8
Oil & Gas	3.3	8.3	-5.0
Insurance		6.4	-6.4
Banks		13.6	-13.6

	Financial Leverage (GSSTFNLV)	Stoxx Europe 600 (SXXP)	Diff. in country weight
Germany	23.3	13.3	10.1
France	23.3	14.9	8.5
Netherlands	13.3	6.0	7.4
Ireland	3.3	0.8	2.6
Norway	3.3	1.2	2.1
Finland	3.3	1.4	1.9
Belgium	3.3	1.7	1.6
Spain	6.7	5.3	1.3
Denmark	3.3	2.2	1.1
Greece		0.1	-0.1
Portugal		0.3	-0.3
Austria		0.4	-0.4
Italy	3.3	3.9	-0.5
Sweden		4.6	-4.6
Switzerland	3.3	13.2	-9.9
United Kingdom	10.0	30.0	-20.0

Source: Goldman Sachs Global Investment Research

Equity baskets disclosure

The ability to trade this basket will depend upon market conditions, including liquidity and borrow constraints at the time of trade.

The Securities Division of the firm may have been consulted as to the various components of the baskets of securities discussed in this report prior to their launch; however, none of this research, the conclusions expressed herein, nor the timing of this report was shared with the Securities Division.

Disclosure Appendix

Reg AC

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