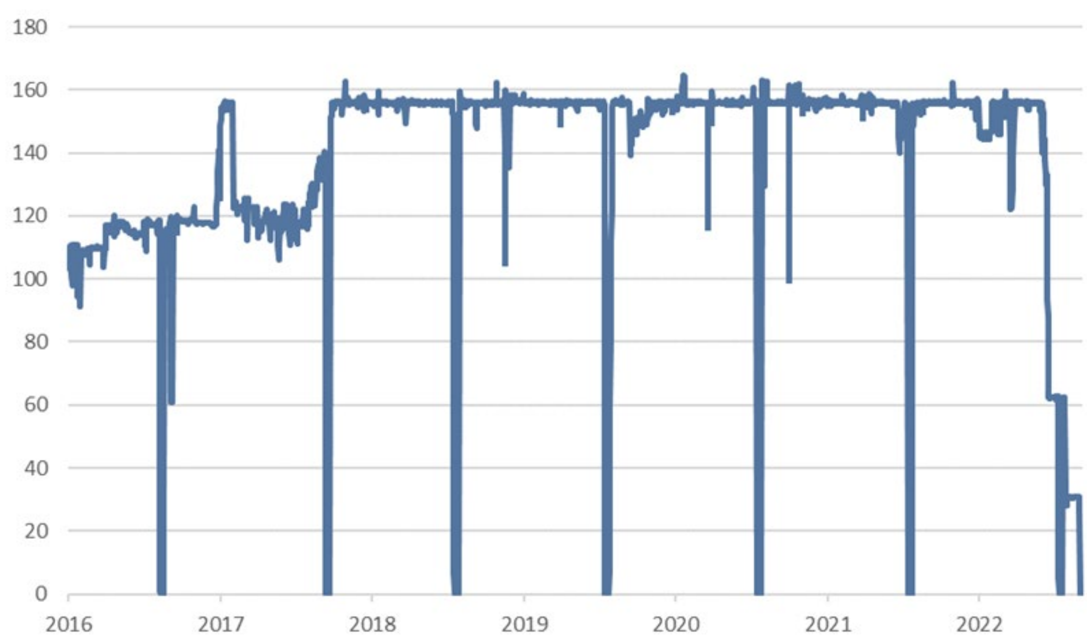
MARKET COMMENTARY

The news out of Europe over the last week has been extraordinary:

1. Group of 7 (G7) finance ministers announced an agreement to set a (unenforceable) price cap on Russian oil sold in the international market.
2. In response, Russia's state-owned oil firm Gazprom announced that it had stopped natural gas flows to Germany through the Nord Stream 1 pipeline (Fig. 1).
3. European gas prices surged and energy firms faced at least $1.5 trillion of margin calls. Finland, Sweden, Germany, and Austria announced bailouts for energy firms. More bailouts are expected to follow, and Finland warned of an "energy-industry Lehman Brothers" moment.
4. Against the backdrop of significant supply constraints, Germany and the UK announced plans to subsidize energy consumption for households and businesses.

Fig. 1: NordStream Gas Flows at Greifswald (MCM.Day, Russia to Germany)



Source: Bloomberg, Mill Creek.

We'll leave it to other pundits to pass judgment and assign blame for this sorry state of affairs, but Europe finds itself fighting a proxy war with its largest supplier of oil and natural gas. US tanker shipments of liquid natural gas have taken up some of the slack thus far. Still, it remains far from clear that a combination of storage and non-Russian imports can keep up with winter demand, particularly if governments subsidize prices and temperatures don't cooperate.

Speculating on the outcome is pure guesswork at this point. When push comes to shove, Germany and Russia might come to some agreement around reopening Nord Stream 1 in exchange for allowing some high-tech exports to go to Russia. A mild winter could alleviate the supply crunch altogether, whereas a harsh winter might lead to economic and human catastrophe. We can say with some certainty that stagflation, a term misapplied to US by a number of pundits over the last few months, is coming for Europe.

Markets are not oblivious to the situation in Europe. The MSCI Europe Index currently trades at its lowest valuation, 11.4x forward earnings, since the 2012 Euro crisis. On a relative basis, European equities are trading at a 35% discount (Fig. 2) to US equities, which is the largest discount since Bloomberg began tracking forward earnings data for the MSCI Europe Index in 2005. On the currency side, the Euro and British Pound are trading at their lowest levels to the US dollar since 2003 and 1984, respectively.

Despite the overhang of bad news, does attractive market pricing represent a risk worth taking in European equities? Not quite yet in our opinion. We currently hold an underweight position on international equities, and therefore, European equities, in our equity portfolios. A valuation and currency recovery could provide a significant boost to European equity returns at some point, but our preference is to wait until the catalysts that would drive such a recovery are a bit clearer before taking a tactical position.

Fig. 2: MSCI Europe / S&P 500 Relative Valuation

Source: Bloomberg, Mill Creek.

QUICK LINKS

- September Update: Powell's Prediction for the (Inflation) Fight? Pain.
- Credit Markets: What We Are Watching Now
- Cash--Not quite trash
- How Will Investors Face Q2 Valuations?

This week's contributor: *Michael Crook, CAIA*