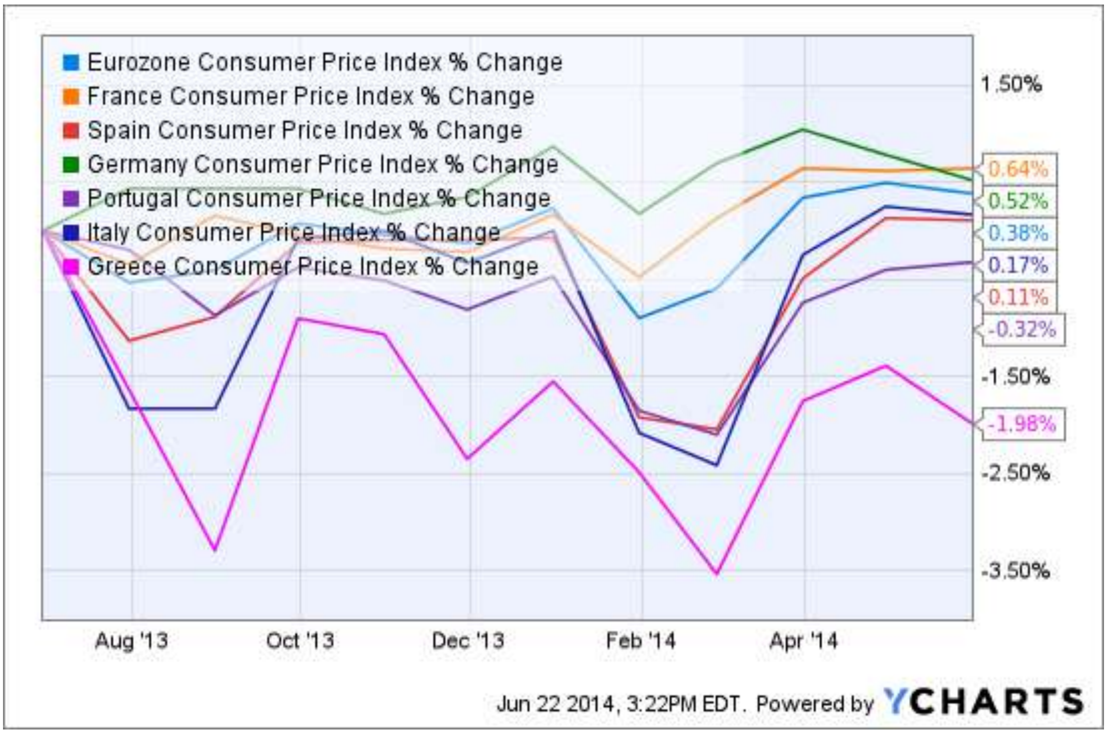
British Stocks: Sweet Spot For European Value

The recent decision by the European Central Bank to reduce a key lending rate to below zero is an acknowledgement that the euro zone recovery is teetering. Exhibit A: inflation rates that are either in or near deflation territory.



Eurozone Consumer Price Index data by YCharts

At the same time, European stock valuations, though having expanded over the past year, are still a better relative value than the U.S. But if the continent's economic malaise leads to a slide back into recession, even well valued stocks aren't going to a haven.

The United Kingdom offers an interesting way to capitalize on the compelling valuations without the same level of economic consternation as exists on the continent. The United Kingdom's 1.75% CPI rate puts it in the camp of the United States, where deflation isn't entirely off the table, but nor is it a front-of-mind-concern as it has to the for Mario Draghi and the Eurozone's central bankers. Moreover, at the end of the first quarter, the 16.9 trailing 12 month PE ratio for the MSCI United Kingdom stock index was below its 15-year norm of 18.

The iShares MSCI United Kingdom ETF (EWU) has in fact picked up steam in the second quarter:

EWU Total Return Price data by YCharts

The five largest positions in the iShares MSCI United Kingdom ETF are HSBC Holdings (HSBC), BP (BP), Royal Dutch Shell (RDS.B), GlaxoSmithKline (GSK) and British American Tobacco (BTI). They may be domiciled in the United Kingdom, but those are five very global companies, with significant exposure to emerging markets, where the case is strongest for long-term growth prospects. Yet they are trading at forward PE ratios that are more in line with a sluggish Euro outlook.

HSBC PE Ratio (Forward) data by YCharts

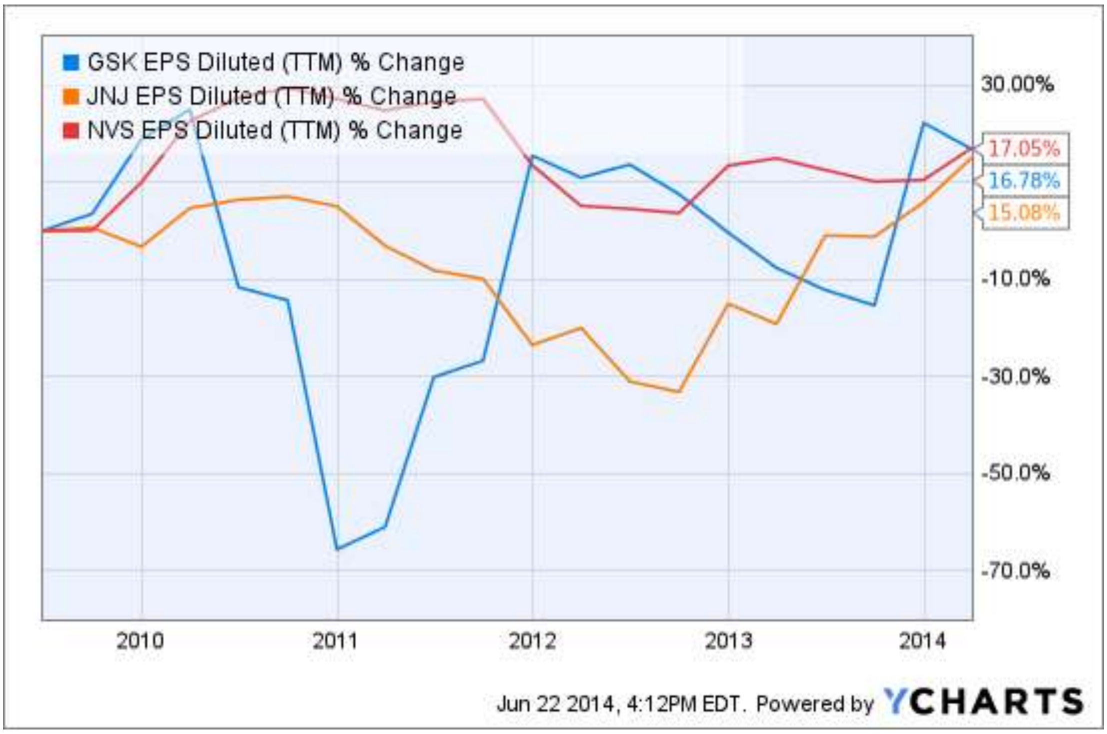
GlaxoSmithKline stands out as an especially interesting UK-based global powerhouse. Its current valuation is well below its five-year norm:

GSK PE Ratio (TTM) data by YCharts

Though no cash flow competition for Johnson & Johnson (JNJ), GlaxoSmithKline has seen a sharp rebound since late 2012:

GSK Free Cash Flow (TTM) data by YCharts

And over the past five years it has actually edged out Johnson & Johnson's EPS growth:



GSK EPS Diluted (TTM) data by YCharts

Meanwhile, there is a 4.5%+ dividend yield. GlaxoSmithKline, whose debt is currently well within the investment grade class, currently delivers a better income proposition than the junky PowerShares Senior Loan ETF (BKLN) of bank loans.

Wine and spirit maker Diageo (DEO) is another top 10 holding of the iShares MSCI United Kingdom portfolio. It also happens to be a top five pick for the standout Oakmark International mutual fund -- and in the first quarter the deep value fund was still adding to its Diageo position. At the same time, the global Oakmark fund established a new position of nearly 2% in Diageo. And Oakmark Equity Income has a 2.5% position in Diageo. The shop that only owns stocks it deems to be trading at a significant discount to their estimate of intrinsic value clearly has consensus that Diageo delivers just that.

While revenue and EPS growth has been strong, Diageo's price-to-book value has not measurably increased.

DEO Revenue (TTM) data by YCharts

With a strong foothold in emerging markets-more than one third of revenue-Diageo is well positioned to capture the long-term growth in consumer spending in those developing markets.