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Viewpoint

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Will we see a liquidity-induced rally in European equity markets? Are valuations likely to increase significantly?

Over the summer months, markets benefited from both positive and negative economic data, believing the latter simply hastened the implementation of Quantitative Easing (QE). Policymakers finally 'got it' and delivered a powerful response. First, Mario Draghi launched his OMT (Outright Monetary Transactions) programme to buy European peripheral bonds as the buyer of last resort. Ben Bernanke subsequently announced his plan to increase QE in order to bring down long-term interest rates, cap mortgage costs, stimulate growth and reduce unemployment. It appears that central banks are determined to avoid deflation at any costs and it looks as if asset prices can rise as a result of result of the European Central Bank's (ECB) activity in bond markets. The banking sector stands to benefit most directly from the ECB's actions and has risen strongly in recent weeks. The ECB's measures will continue to support this sector and markets in general, but we are sceptical of the longer-term sustainability of a sharp bounce. This is because Europe will experience weak or negative economic growth in 2012 and growth will remain low thereafter, hindering a recovery in the banking sector's profitability. Worse still, banks are being forced to deleverage and are subject to increasing regulatory pressure (such as the Basel III restrictions and the proposal to elevate the ECB as a super-regulator of a Eurozone banking union). But Europe is cheap on both absolute and relative measures, trading on less than 11x 2013 EPS and is 40% cheaper than the US as measured by P/BV. Despite recent strong moves in markets, the equity risk premium is still at elevated levels.

Given that cyclical stocks have rallied strongly in recent months, can they climb further?

There is good value to be found among European cyclical stocks and we are especially attracted to the better-quality, cyclical companies; this valuation support could boost any short-term rallies caused by ECB initiatives. However, we are cautious about economic prospects in Europe and, as with the banks, this tempers our longer-term enthusiasm for domestically-focused cyclicals. Pressures exerted by bank deleveraging and austerity, and the consequent impact on consumer and industrial confidence will curb investor appetite. Growth in southern Europe will be particularly weak, not just in Greece, but in Spain, Portugal, and Italy too, where weakness will also be more prolonged than elsewhere.

Can attractive opportunities be found among European companies focused on domestic markets?

In terms of the domestic market, we are cautious about Europe's growth prospects. However, we believe that there are opportunities on valuation grounds, both among those stocks that have been oversold, and in businesses operating in particular niches, which are relatively immune from the weak economic backdrop. We focus on enterprises whose competitive position delivers robust pricing power and, therefore, strong, predictable and sustainable returns.

> ***"Europe is cheap on both absolute and relative measures"***

There is currently a strongly-held consensual view that investing in European companies benefiting from the weakness of the euro, with exposure to countries that are growing at a fast pace - emerging markets and especially China - is an attractive strategy. We held this

view (which was successfully reflected in our portfolios) long before it became consensual, and it has boosted our strong performance. However, with China slowing and good valuations evident among domestic stocks, a more balanced approach is now appropriate.

Do you think there will be any slowing in the implementation of fiscal austerity in Europe and would such a development prove beneficial?

The key challenge posed by the euro crisis is the necessity to achieve the right balance between curbing government expenditure to contain debt and ensuring that austerity measures do not strangle economic activity. Reduced growth caused by overzealous austerity will undermine government revenues and exacerbate the debt problem. Different solutions to this problem will be found across Europe, as each country faces a different situation. We are cautious about businesses that are heavily reliant on government expenditure, as they will be vulnerable to spending cuts, and we are also wary of companies which are easy targets for governments greedy for revenue. For example, the telecoms and utilities sectors and the banks are all vulnerable to marauding lawmakers eager to replenish the tax coffers. However, current accounts are improving in many European countries with Ireland, Italy, Portugal and Spain all moving into surpluses. Exports are performing strongly and labour costs have adjusted. This will contribute positively towards GDP growth in these countries. Greece however, remains firmly in deficit.

Has the ECB's bond-buying plan increased the earnings prospects and the visibility of the European financial services sector?

The plan has reduced the tail risks, i.e. the chance of a eurozone break-up. Thus, the plan has alleviated the stresses facing markets and given some companies breathing space to recover, but earnings' prospects remain challenged by headwinds.

Poor economic growth will take its toll:

- There are assets which need to be written down further, such as Spanish real estate and the loans dependent on it.
- The banking industry remains under pressure to deleverage by reducing the size of its balance sheet and to increase capital.
- Governments may be wary of allowing banks to enjoy strong profits growth, given that this is likely to prove unpopular with electorates. Moreover, if the financial sector were to see healthy earnings growth, there is a high probability that the authorities would intervene either with regulatory curbs or taxes.

However, the financial services sector benefits from some positive influences too:

- The deleveraging phase and the writing-off of assets has been under way for some time and thus, although the economic outlook remains poor, much of the hard work required to rebuild the industry has already been undertaken.
- The ECB's measures will free up capital markets, allowing interbank markets to operate more effectively and thus enabling investment banks to generate revenues via M&A and new issue activity.

One of the greatest attractions of the banking sector is that, having underperformed so drastically, valuations in a number of areas now appear more compelling, particularly on the basis of price relative to tangible book value. Post Lehman, it is unthinkable that any

regulator or government would let a major bank go bust, and it is likely that the stronger banks will benefit at the expense of their weaker peers.

What are the main risks currently facing investors in European equities?

First, economic growth may disappoint again. Austerity measures may be too severe and will curb consumer spending, damaging economic growth and the prospects for corporate earnings.

Second, the slowdown in emerging markets may prove worse than expected – economic growth has already slowed in China and a response to this trend has been delayed by a change in political leadership. Emerging economies are an increasingly important engine of growth for Europe and any slowdown among these markets, or in the US, would be unhelpful.

A third risk is the threat posed to ECB activity by a potential Spanish bailout and challenges relating to constitutional law in Germany and other eurozone members.

Fourthly, there is a danger that the Germans and the Finns press for draconian levels of austerity in some of the more problematic countries, provoking a bitter backlash among the politicians and ultimately the electorates in affected nations.

Another risk is that markets have moved ahead in spite of a slowdown in earnings growth. Equities have come a long way from their 2009 lows and volatility is at low levels. We need economic growth to stabilise and earnings to begin to improve for the market rally to be sustained.

The final risk is that QE, which has been boosted in the US, Japan and the UK and is taking place in all but name in Europe, will cause long-term damage to the global economy by igniting inflation. We regard this as a much longer-term risk, because in the short term the velocity of money is low and we believe that QE is supporting asset prices.

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