Viewpoint

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European Equities – August 2013

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The Meltup

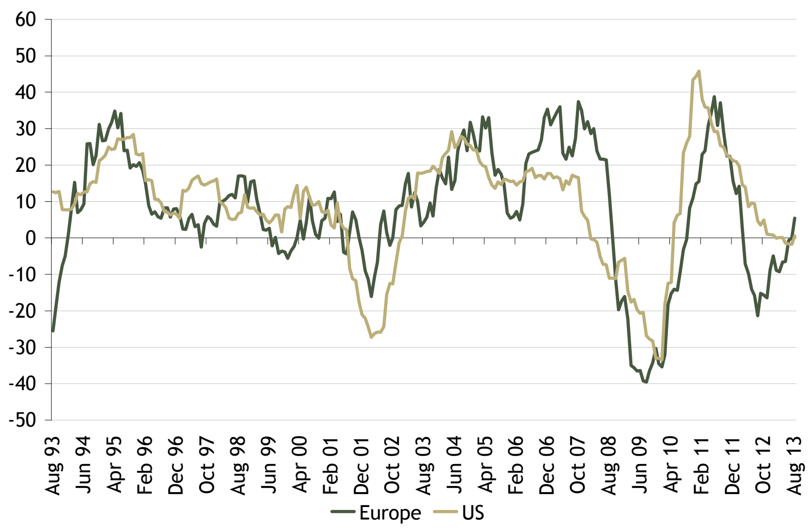
Only a few months ago the eurozone was in meltdown. Bond spreads were widening, the political environment appeared fragile and earnings estimates were falling. It was hard to see any positives. However, it does now appear that the economic background is improving. Furthermore, valuations are attractive.

According to Eurostat estimates, the 17 eurozone member states showed seasonally-adjusted growth of 0.3% in the second quarter of 2013. Significantly, Europe's largest economy Germany saw growth of 0.7%, but France also performed well, registering a surprisingly strong figure of 0.5%. In Portugal, the economy grew for the first time in two and a half years – by as much as 1.1%. Meanwhile, Spain and Portugal reported a drop in unemployment for the first time in two years.

Business confidence is also recovering. Eurozone firms are more optimistic than they have been for 18 months. The Markit purchasing managers' index rose from 48.7 to 50.5 points, taking it above the threshold marking growth.

This should point to an uptick in earnings, which have suffered a long period of negative revisions. Moreover, the pace of change is particularly interesting versus the US market. European earnings are down by 4% year on year (compared to the 2% decline seen in the US) but it is clear from Chart 1 below that we have reached a turning point.

Chart 1: Europe vs US earnings growth, 12 month trailing EPS growth, % year on year



Source: Absolute Strategy Research Limited/Thomson Reuters Datastream

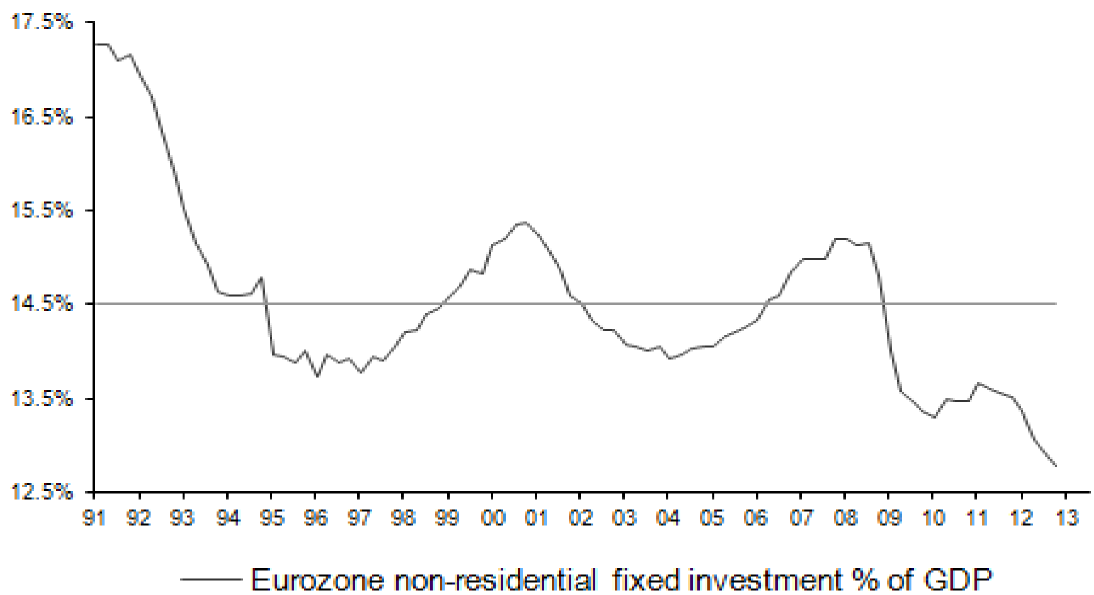
There has also been some better news on the consumer side. Consumer spending in the eurozone stabilised in the first quarter of 2013 and there are signs that this continued in the second quarter:

- Consumer confidence jumped to -17.4 points in July, according to the European Commission, from -18.8 points in June, beating market expectations for a rise to -18.30 points. The reading was the best since August 2011.
- Car sales in Germany, France and Spain rose in July, while the decline in Italy was the least this year.

How are corporates faring?

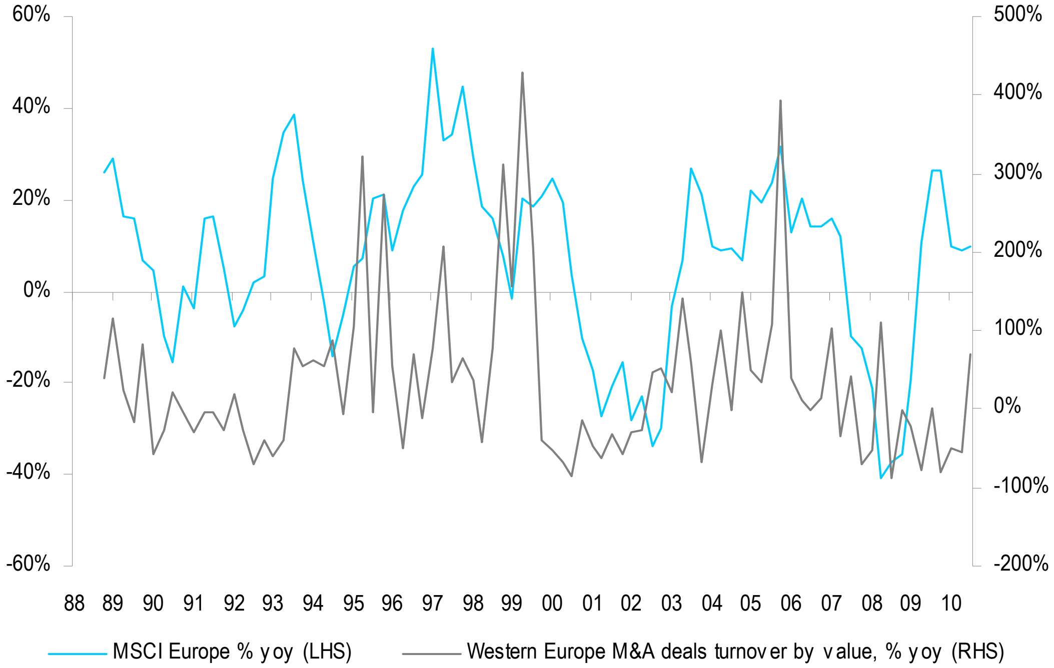
Businesses have been notably reluctant to spend through the uncertain times of the European crisis and capital expenditure (as a share of GDP) is at its lowest level for more than 20 years. On top of this, merger & acquisition (M&A) activity (see Chart 3) is at a low level. However, there are now signs that transactional activity is increasing as businesses become more financially secure. The benefits of industry consolidation and cheap funding (for good risks) means that many deals undertaken now will have lasting benefits for shareholders in terms of operating efficiency, pricing power, and sales and profits growth. With borrowing costs attractive, any increase in animal spirits should drive up capex and M&A activity, further supporting economic activity.

Chart 2: Eurozone non-residential capex as a share of GDP



Source: Eurostat

Chart 3: Western European M&A activity

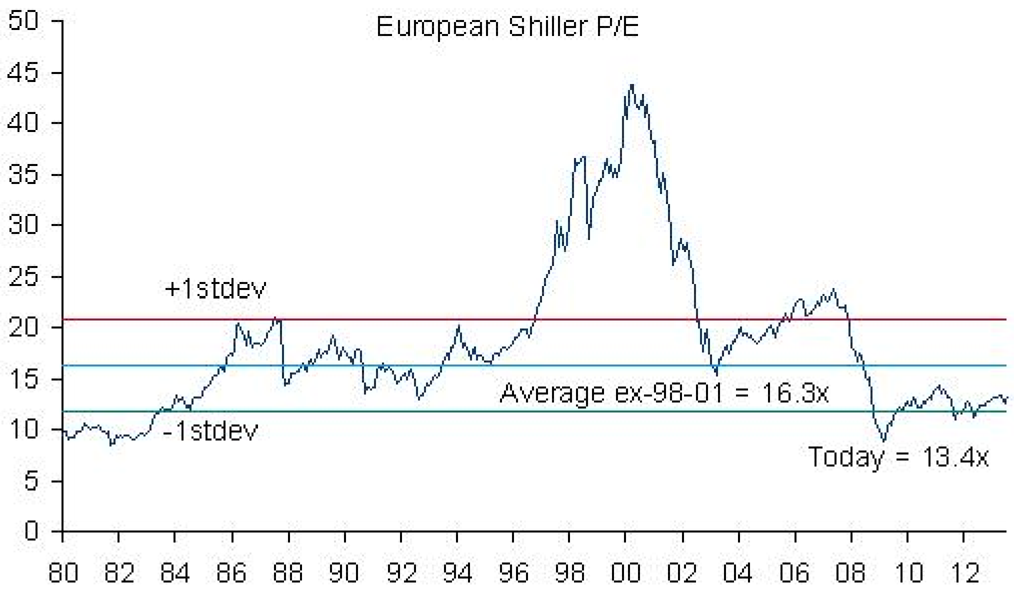


Source: Datastream

Valuations remain attractive

Whilst we are some way off the rock bottom valuations of 2009, European equities have lagged the US and UK and also look cheap compared to history.

Chart 4: Europe – Shiller PE – running below long-run average



Source BofA Merrill Lynch European Investment Strategy

Conclusion

Europe remains beset by challenges, whether in terms of politics, the eurozone's institutions or the response of the authorities to the crisis. Certainly, if you wanted to create an economic zone representing 17% of global GDP, then you would not start from here. However, we do believe that there are signs that the outlook is finally brightening.