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Viewpoint

European equities
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William Davies
Head of European Equities

Concern over sovereign debt, and potential problems within continental banks, weighed heavily on European equities in 2010, and we expect financial markets to experience further volatility this year. Investors will be seeking reassurance that the authorities have the wherewithal to allow peripheral members to overcome their short-term financing difficulties. In addition, they will be expecting the introduction of measures that will allow the eurozone not just to survive but to flourish in the longer term.

The year of living dangerously

Last year, for the first time since the euro's inception in 1999, its very survival was being seriously questioned as peripheral members such as Portugal, Ireland, Italy, Greece and Spain struggled with stagnant economies and apparently unsustainable levels of sovereign debt. Long-standing doubts about the one-size-fits-all monetary policy, and concerns over the lack of fiscal convergence, rose to the fore. However, the €750bn (£616.5bn) IMF/EU package announced in May, as well as significant loan packages to Ireland, helped to quell these fears. Such measures showed that politicians were committed to ensuring the survival of the euro area. As a result, European equities were able to advance overall during the year, rising particularly sharply in December as an improving global economic outlook bolstered investor confidence.

New issues test markets in 2011

Yet critics argue that measures taken thus far have simply addressed short-term liquidity problems rather than tackling issues that caused these difficulties in the first place. The eurozone will certainly face further significant challenges in 2011. During the first six months of this year, investors are likely to refocus on the question of sovereign debt, as the governments of peripheral economies, as well as those countries' banks, come to the market seeking fresh funding. However, the doubts about the eurozone may well ebb, and the outlook for European economies and markets will improve markedly, if the new issues due in the first half of 2010 are well received by investors.

The first signs are encouraging. A €5billion bond from the European Financial Stability Facility (Europe's sovereign bailout fund) in January was oversubscribed by nearly nine times. This is also likely to prompt other issuers to come to the market. Moreover, such interest suggests increasing investor confidence that the eurozone is getting to grips with the debt crisis that has haunted it for over a year.

Periphery rebounds

Sentiment towards the eurozone's peripheral countries certainly improved markedly towards the end of 2010, a trend that appears to have continued into 2011. Investors had been heavily underweight in their exposure to these peripheral markets, yet have begun to rebalance portfolios substantially towards non-core markets going into 2011. Consequently, markets such as Italy and Spain have been among the best performers so far in the New Year.

This largely reflects the view that peripheral economies will get the support they need in 2011 from stronger eurozone members, such as Germany. The collapse of the eurozone would certainly not be in Berlin's interests. Germany has invested too much political – and financial – capital in the eurozone project to sit idly by while it ruptures. Moreover, Berlin does not want a repeat of the 1980s and the 1990s, when neighbouring countries launched a repeated round of devaluations in order to remain competitive, thus undermining Germany's export competitiveness.

Opposition politicians in countries undergoing severe austerity measures, and enduring high levels of unemployment and falling living standards, may of course be tempted to back demands to leave the euro. Yet it is far from clear whether electorates will heed such siren calls. A decision to ditch the Single Currency may not be an economic panacea, since existing sovereign debt would remain denominated in euros, and a country embarking on such a journey would be left with a weak currency, and may thus face greater difficulty in servicing its debts. Defaulting on the debt would inevitably leave the country facing enormous economic problems.

Three-tier economy

We believe that the eurozone will continue to comprise a three-speed economy over the coming year and beyond. The fastest-growing cohort consists of Germany and the Nordic countries, which have strongly competitive economies and whose exports, bolstered by the weak euro, are fuelling growth. Meanwhile, the struggling peripheral economies, with high levels of sovereign debt and massive public sector deficits, populate the slow lane. Countries such as France, which lie in the middle, are benefiting from interest rates set at appropriate levels. By contrast, rates are probably too low for the most dynamic group and are certainly too high for the most sluggish.

Opportunities for equity investors

Last year, investors were able to exploit the divergent fortunes of the European economies by focusing on exporters. During the period when the sovereign debt crisis depressed European equities in general, astute investors purchased stock in those businesses focused upon fast-growing global areas such as emerging markets, and those sectors whose foreign sales benefited from the weakness of the euro. Companies that fell into this category included luxury goods makers such as LVMH and Swatch, and carmakers such as BMW. However, the value of these types of companies has risen significantly, and investors are now looking at other areas to unearth value. This explains why they have begun to turn their attention to markets that languished last year, such as Ireland and Spain.

We certainly believe that markets will be less polarised this year than last, and that investor demand will widen from its narrow focus on exporters. At Threadneedle, for example, we continue to invest in the companies that performed well last year, such as exporters; however, we also plan to focus increasingly on businesses that will benefit from strong domestic demand in the faster-growing countries of the eurozone, namely Germany and the Nordic belt. Metro, the German retailer, for example, will profit from strengthening domestic demand as rising confidence in the expanding economy prompts Germans to spend more freely.

In addition, we have identified areas that have the potential to perform strongly this year due to global trends. The high cost of energy, for example, is encouraging businesses to invest in products that increase their energy efficiency. Schneider Electric of France, which supplies technology and integrated solutions to optimise energy usage, should be a prime beneficiary.

Syngenta of Switzerland, the world's biggest supplier of chemicals for agriculture, is another company that we like. Buoyant soft commodity prices should drive demand as farmers seek to increase yields by buying the company’s products.

Summary

Overall, valuations of equities remain very attractive and we believe we could see a 20% appreciation over the next two years with investors receiving another eight per cent in dividends, giving a total return of nearly 30%. There are of course threats to this outlook. Unlike their US counterparts, European banks have yet to recapitalise and have large exposure to sovereign debt. Equities will also remain volatile as the sovereign debt issue plays out. Despite these caveats, we see excellent prospects for European equities.