

July 2011

Outlook on Europe

The European equity market was volatile during the second quarter, as the market attempted to reconcile the attractive valuations and growth of the core countries with the uncertainty stemming from peripheral countries, most notably Greece. We continue to see scope for share price progression in European markets, despite the possible headwinds to global economic growth.

The Greek sovereign debt crisis entered a new phase, unfortunately accompanied by weakening economic data from the U.S. and China. The question occupying the minds of many investors is whether this period of weaker sentiment is the result of temporary macro issues, such as the “knock-on” effects of the Japan earthquake, or a more worrying long-term trend.

Europe is currently in a slower mid-cycle phase of economic growth, though we do not believe this tells the full story of the continental European economy. Europe might now be described as a “three-speed” economy, with noticeable differences in the pace of growth in different groups of countries. The first and most successful of these is the manufacturing base, which appears to be growing at a fast rate; this is particularly apparent in Germany and Sweden. Germany’s economic growth is robust with GDP growth in excess of not only the majority of developed nations, but many emerging markets as well. The second tier is represented by the rest of the core of Europe, such as France, where growth has been slower, but still positive. That leaves the periphery, which is continuing to struggle under the weight of high debt levels and severe austerity measures, leading to flat or even negative growth.

In Greece, the recent vote of confidence in George Papandreou’s government, and the acceptance of austerity measures, has secured another bailout worth €12 billion to facilitate debt repayments. We hope to see some stability return to the markets as a result, at least in the short term.

Germany has seen unemployment drop and manufacturing data beat analysts’ estimates, while consumer confidence has continued to rise in direct contrast to some of its neighbors. A positive impact of the troubled periphery of Europe is that the value of the euro has been held back, directly benefiting the exporting countries, such as Germany.

One clear signal that the core of Europe is on a different path to the rest of the developed world, and certainly the periphery of Europe, has been the European Central Bank (ECB)’s decision to modestly raise interest rates. Exceptional growth in Germany in particular has allowed the ECB to give a more robust response to inflationary pressures than many other developed markets and giving themselves more room to maneuver in the future. This environment has helped inflationary pressures begin to dissipate, in addition to a fall in commodity prices.

Even if we do not include Greece, there are still a number of serious issues with regard to a financial system still under pressure. The risk of large policy mistakes around the globe remains. Germany and other core European countries, due partly to their history, are enforcing cuts to government spending, in some cases on a significant scale. On the other hand, the U.S. is debating whether to prioritize spending or deficit reduction. The room for error in either case remains smaller than we would like.

With such uncertainty in the global economy and with government finances across Europe a concern for many investors, the focus is likely to be on corporate earnings. Many investors will see this quarter’s earnings as clear sign of whether companies are weathering the poor macro news in the global economy. Therefore, earnings will need to be robust to build confidence in equity markets.

However, we believe investor confidence will be bolstered by the pickup in corporate activity across the globe. Positive indicators include growth in both mergers and acquisitions and organic investment. Such activity is picking up from very low levels, and has seen a significant increase this year.

As we move into a mid-cycle phase of economic growth, we expect the market to remain resilient in the face of macro pressures. We believe company earnings growth will remain positive, though slightly weaker than the earnings momentum seen during the recovery period last year. Despite the recent setback in share prices, we still believe Europe is attractive from a bottom-up perspective, as quality companies are now undervalued and available on compelling valuations.

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