

January 2012

Outlook on Europe

Without question, 2011 was a turbulent year for Europe and its markets, politics, and currency. It is easy to see how the start of 2012 could bring more of the same. However, it may now be possible to start to define some of the building blocks that will make up the Euro area going forward. While a silver bullet has not been forthcoming, the political will behind the euro is evident. Within the equities market, it is noteworthy that following the highly correlated sell-off over the summer, there is now a greater dispersion of returns, with clearer winners and losers among European companies. So, while markets are likely to remain volatile as the political drama unfolds, we believe there will continue to be opportunities at the stock-specific level.

The focus of politicians this quarter has been on a so-called “fiscal union.” However, the facts at hand seem to point more toward increased fiscal discipline at a country level and less toward a fully centralized system of taxation and fiscal transfers. It could in fact be argued that the idea of limiting debt to GDP in Eurozone countries by ensuring that budgets are balanced or in surplus, with penalties for breaches, is a way of keeping full fiscal union at bay, not encouraging it. Following the most recent announcements on December 9, markets reacted with caution, wary of whether such measures will lead to the long-term goal of a more stable, structured, and prosperous Europe.

Though these Eurozone proposals were not warmly received, despite being a tentative step in the right direction in our view, there has been some progress in individual countries that have been under pressure in the past few months. Greece received the €8 billion tranche of its bailout after the Troika of the European Central Bank (ECB), International Monetary Fund (IMF), and European Union (EU) agreed that the country was on schedule to meet its deficit reduction targets. The country has installed a technocratic government overseen by former ECB Vice President Lucas Papademos following George Papandreu’s resignation after his ill-timed call for a referendum on the bailout package. However, there is still a high degree of skepticism surrounding Greece’s ability to ultimately meet either its growth or deficit reduction targets.

Greece was not the only country to find itself with a new government as a result of the Eurozone crisis. Silvio Berlusconi resigned as Italian Prime Minister in early November, as 10-year sovereign Italian bond yields began rising toward the 7% mark, finally breaking that barrier on November 9, a day after the resignation. In our view, markets have continually underestimated Germany’s willingness to allow financial markets to become distressed. This in turn is forcing the agenda and is putting pressure on the weaker member countries to make structural changes. In Italy’s case, former EU Commissioner Mario Monti was asked to form a new technocratic government and, at least in the short term, there seems to be a political consensus that austerity measures will move ahead.

As expected, Spain also found itself with a new government, elected in the traditional manner. The Partido Popular have come to power with a strong majority and a mandate for significant deficit reduction in the coming years. We believe that politics and changing governments will continue to draw attention in the year ahead with Greece, France, and the Czech Republic all holding elections in the coming months.

We cannot discount the possibility that European leaders will continue to allow markets to force the agenda, causing meaningful moves in yields and keeping volatility high. While the desire for structural improvements is positive, in our opinion, this could prove to be a risky strategy as it may have a negative impact on Europe’s growth. For example, increased borrowing costs and stricter capital requirements are putting pressure on the banking system, which could potentially cause a contraction in credit. However, the ECB appears to be concerned about this and we believe that the coordinated measure by central banks at the end of November to ease dollar funding pressures was a step in the right direction. The ECB’s recent decision to provide a three-year unlimited loan facility to the banks while also lowering collateral requirements is also a potentially positive move.

Economic growth across Europe has clearly slowed as the year has progressed. The duration and extent of this slowdown is currently hard to assess; however, recent data points do not indicate a 2008-like contraction, in our view. Purchasing Managers Indices (PMI) in recent months have come off the lows of late summer, with the October composite PMI for the Eurozone improving from 46.5 to 47.2, closer to a return to expansion. Many had expected a far greater contraction in macroeconomic figures than we have seen. Europe continues to run at different speeds in different regions, with the south continuing to struggle, while the north fares better. This was apparent in the latest set of employment figures for November, with the German unemployment rate falling from 5.7% to 5.5% and the Spanish unemployment rate rising from 22.5% to 22.8%.

Companies have begun to reflect these weaker trends in their outlooks, but the amount of profit warnings has so far been relatively limited and has mostly been contained within the industrials and consumer sectors. While more warnings are likely, it does appear that companies are better prepared for a slower environment; for example, inventory levels are lower and more use has been made of temporary workers.

We believe that we will likely continue to see winners and losers in the current climate; some companies have performed well during recent months, while others have fallen significantly. The stocks that have weathered the market volatility have mostly been strong businesses, whether defensive or cyclical. Those that have fallen have been generally weaker and we believe this indicates a return to a more fundamental stock-specific equity market, with greater dispersion of returns.

How the current situation develops in the Eurozone and what the end-game will be likely depends as much on politics as it does on economics. In the short term, this is likely to continue to cause European equity markets to be volatile and opaque as politicians take incremental steps in a drawn out process. The ECB sounds supportive but prudent, and we believe the markets continue to hope for a comprehensive solution. However, in the long term, the structural changes, deregulation, and a new sense of fiscal discipline should make the Eurozone more efficient and productive, in our view.

In conclusion, geopolitical risks are still elevated and the downside risk attached to a negative turn in the economic cycle is worrying. However, to an extent, we believe this has already been priced into markets. At present, we find that valuations and stock-specific opportunities appear attractive in many areas, and the corporate sector's cash flows and balance sheets also appear compelling in an uncertain world.

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