

Schroders

2010: A year in Europe

Gary Clarke, Head of European Equities,
looks ahead to 2010



- Evidence suggests that European economic recovery is underway – although, as stimulus winds down, there is still a chance of a nasty hangover
- Public sector debt and the prospect of rising unemployment may act as headwinds; inflation kept at bay for the time being
- Following aggressive cost cutting, European companies are well-positioned to deliver positive earnings growth in 2010.

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European recovery in a global context – Whisper it quietly, but boring old Europe has fared pretty well through the economic crisis of the last few years, at least compared to the US and the UK. France and Germany both emerged from recession in the second quarter, partly as a result of fiscal stimulus, including government incentive schemes such as ‘cash for clunkers’. Second and third quarter corporate earnings were better-than-expected, albeit as result of aggressive cost-cutting and restructuring rather than top-line growth. There is still a chance of a nasty hangover as fiscal stimulus gets withdrawn, but a more important trend in our opinion is the notable pick up in trade. Indeed, exports have driven the lion’s share of growth for Germany and France.

Exports remain key to continued recovery

It is often forgotten (or wilfully ignored) that developed Europe now only makes up 60% of total revenues for European corporates. Just over ten years ago this figure was around 70%. The major change has come with the significant increase in the share of revenues coming from the emerging markets – which currently account for nearly 24% of European revenues. This is around 50% more important than revenues from the US, and is a crucial change in dynamic as we consider some of the headwinds facing Europe.

Why we remain optimistic

Attractive valuations

Despite the most recent market rally, valuations are still not looking stretched. Current estimated European p/e multiples are coming in near 12.5x 2010 earnings. In addition, European equities look good value relative to other regional equities. If, for example, we compare European and US equity Shiller p/e multiples over the last 30 years*, current European p/e multiples are coming in well below historical averages, sitting close to historical lows relative to US multiples.

Despite the fact that European equities have raced ahead, gaining over 50%, equity dividend yields are still at or above government bond yields. In a world where central banks continue to print money and look determined to create inflation, ‘real assets’ like equity, property and commodities remain attractive.

In what has been a relatively narrow cyclical-led rally since March, it is also worth viewing valuations at a sector level. Indeed, if we consider materials versus healthcare, following the enormous cyclical re-rating we saw in March, we are seeing a much greater disparity in these sector valuations. The picture that is now emerging is one where the highly cyclical sectors are approaching the top of their relative valuation ranges; whilst the more defensive sectors are hitting the bottom of their historical trading range. This, in our opinion, has provided some very attractive opportunities. In particular, we have trimmed our exposure to some of the riskier cyclical stocks that we believe are reaching fair value, and invested in a greater number of large, defensive, high quality names, that are offering good value, and which have good structural growth drivers that are yet to be rewarded by the market.

*Source: MSCI, Morgan Stanley Research, September 2009.



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Gary Clarke, Head of European Equities

Gary has 14 years of investment experience. He joined Schroders as a European equities fund manager in 2005 having previously managed funds at Gartmore, HSBC Asset Management and Rothschild Asset Management.

Gary became Head of European Equities at Schroders in 2008.

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Loose monetary policy – here to stay?

In the absence of clear evidence that the economy has embarked on a sustainable recovery, it remains difficult to predict when the ECB may raise interest rates. What is more, central banks in general have signalled that monetary policy will remain easy for some time, and excess spare capacity and rising unemployment should, in combination, serve to keep inflationary pressures at bay for the time being.

Cash reserves

Another significant factor to be considering is the sheer volume of assets taken out of Europe over the last two year period. In 2007 and 2008, the industry saw over €80 billion in outflows from European equities. What has been interesting is that, in January and February of this year, when the markets were down 20%, we did not see the same level of outflows, as investors looked to have come down to their minimum allocation to European equities. Crucially, vast amounts of this money is still sitting in cash, with investors yet to re-enter the market. For investors looking to re-allocate assets, they will not be building an overweight position to European equities or to equities overall but, rather, closing an underweight position. With such a large volume of assets looking for a re-entry point into the market, we could see an influx of funds providing further support to markets going forwards.

Challenges to growth

The increasing strength of the euro – The growing strength of the euro has raised some concerns about the potential impact on growth. Europe’s single currency has been on a steadily rising trend against the US dollar this year, which has had many questioning how this might impact export growth as we enter 2010. We believe that the headwind of currency is less significant than it has been historically, helped by the declining importance of the US as an export market. If we consider a scenario where the US dollar fell a further 10% relative to the euro, it is estimated that overall earnings for Europe would fall by some 1.5% versus around 3.1% two or three years ago – evidence of Europe’s reduced dependence on the US market.

Public sector debt – Further headwinds for Europe include the burgeoning public sector debt which, in the wake of the financial crises, has seen debt levels rise to well above long term averages and above where the Stability and Growth Pact has set its gross debt levels. We can expect further cuts to government spending and we are likely to see an increase in privatisation. It is also probable that income tax and property tax will be increased, which may have a knock-on effect on the consumption outlook for Europe.

Rising unemployment – Unemployment growth remains a real concern. Europe has cut costs more swiftly than in any previous recession and labour rigidity will likely result in an up-tick in unemployment going forwards which, combined with increased tax pressure, could weigh on consumption as we move through 2010. However, consumption has not been a major driver of growth for Europe in recent years.

Conclusions

We have evidence that the European economic recovery is underway, largely led by France and Germany, as encouraging economic data and better-than-expected corporate results look to be paving the way for a return to sustainable growth. Still, we are by no means in for a smooth ride, with the prospect of rising unemployment and weakening consumer demand as government-sponsored liquidity and incentive schemes wind down.

At a corporate level, many European companies have a well-established global presence, and have shown the ability to adapt their operations to contend with varying economic conditions. These same companies have also been particularly effective in reducing their cost bases to preserve margins, which has left them well-positioned to deliver positive earnings growth in 2010.

Looking ahead, we would expect the market to broaden out, beyond just rewarding the highly cyclical areas of the market. With European valuations not looking particularly stretched they are not acting as a cap to continued equity market growth. Dividends yields remain very competitive relative to alternative asset classes, and there are significant amounts of cash reserves on the sidelines that may provide welcome support to valuations going forward.