December 2009

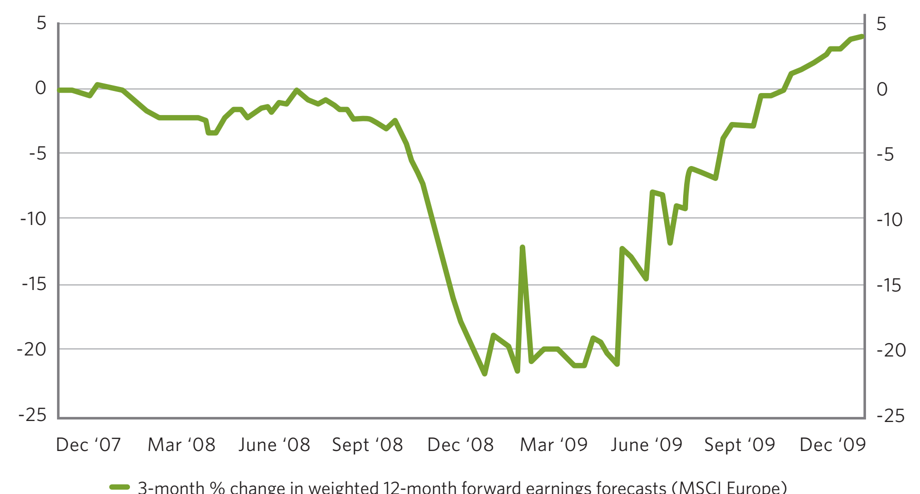
European prospects for 2010

In this paper we take a look at why Europe's economic recovery caught most observers by surprise in 2009 and we examine the outlook for Europe in 2010. We conclude that the fundamental outlook is positive. Some risks are being over-estimated (such as the prospects for Eastern Europe), while others are being underappreciated (such as the tensions between the core and the periphery of the eurozone).

European recovery

European economies proved to be more robust during 2009 than many commentators had anticipated at the beginning of the year and, against a backdrop of improving economic conditions, and with the support of large-scale stimulus measures by governments and the European Central Bank, Europe's equity markets have rallied strongly since March. Against this backdrop, forecasts of European companies' earnings are gradually being revised upwards.

EUROPEAN CORPORATE EARNINGS FORECASTS



Sources: IBES, Thomson Datastream, December 2009

News of an unexpected recovery in output in France and Germany during the second quarter fuelled expectations that the worst of Europe's economic downturn was over, with the economies of those countries expanding by 1.1% and 1.3% respectively on an annualised basis (compared with the previous quarter) during the three months to the end of June. In the summer months, data continued to point generally to improving conditions across much of the region, and the eurozone as a whole was reported recently to have registered growth of 1.5% in annualised terms during the third quarter of the year (compared with the second quarter).

Europe's improving economic fortunes have been attributable to three key factors:

1. The influence of policy actions by the European Central Bank and by governments across the region

2. In contrast with the United States, a relative lack of dependence on (debt-fuelled) consumption

3. Recovery in a number of European manufacturers' key export markets and associated replenishment of those manufacturers' inventories

The influence of policy actions

Europe's monetary and fiscal policymakers have put in place concerted measures over the last two years to try to ease the region's economic and financial-market woes.

Initially, the European Central Bank sought to alleviate anxiety in credit markets by providing liquidity to the financial sector, rather than by cutting rates. Europe's monetary policymakers actually raised rates in July 2008 in response to their apprehension about mounting inflation pressures; after all, based in Frankfurt and modelled on the Bundesbank, the ECB has always regarded its credibility in scotching the threat of inflation as indispensable to good central banking and to the maintenance of 'sound' money. However, the ECB reduced the cost of borrowing progressively from 4.25% to 1% between the fourth quarter of 2008 and May 2009 in recognition of the toll that troubles in those markets were having (indirectly via weakness in other major economic regions, as well as directly) on the wellbeing of European consumers and businesses.

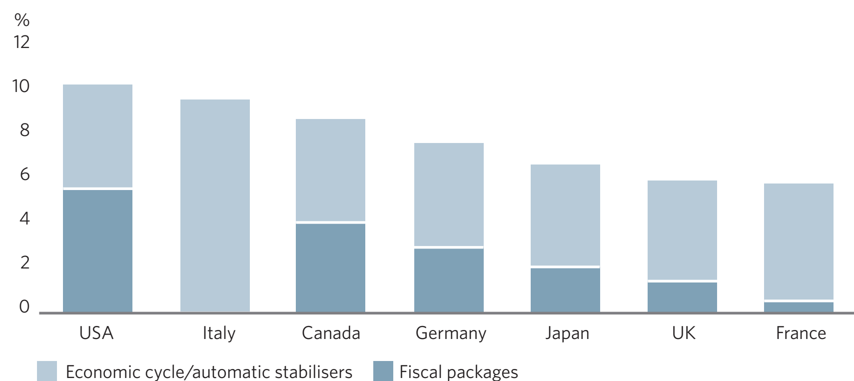
In tandem with lower interest rates, the ECB has implemented a number of large-scale liquidity-related operations over the course of the last six months. In June 2009, it announced that it was providing unlimited one-year funds to commercial banks at a rate of just 1% (in exchange for a wide range of collateral assets), prompting the Financial Times to remark that only a banker 'with a rock for a head' would refuse funds on the terms offered by the ECB. The June measure amounted to €442 billion, equivalent to 10% of the eurozone's narrow money supply or €1,300 per eurozone citizen, and 1,100 banks across the region took advantage of it. The central bank followed its early-summer munificence with a further one-year 'repo' in September, and it was scheduled to make a decision at the December meeting of its governing council about whether to extend such lending beyond the scheduled expiry of such operations on 16 December.

Government policies, too, have been highly stimulative to European economies, albeit that they have not had the 'headline' impact that the policy responses of, for example, the US and UK governments' actions have had. In much of Continental Europe, the transition from employment to unemployment is much more gradual than it is in the US and the UK, given the operation of a number of welfare nets, to which economists sometimes refer as 'automatic stabilisers' because they act to stabilise economic activity during a downturn.

In France, for example, workers receive substantial redundancy payments and the state pays almost two-thirds of their income for the following 18 months. In Germany, the Kurzarbeit scheme (of reduced-time working) allows companies to reduce the length of the working week, with the state making payments to supplement workers' income to replicate the remuneration they would receive were they still working on a full-time basis. Under the German welfare system, it makes perfect sense for the government to participate in such a scheme given the large costs involved in funding unemployed workers. The Kurzarbeit scheme is also highly beneficial in affording companies time to decide how much capacity they require on a longer-term, structural basis (rather than according to near-term, cyclical fluctuations in economic fortunes).

Meanwhile, in Italy welfare policies are so generous that their effect has been to raise Italian fiscal spending to such an extent that, despite the fact that the Italian government has announced hardly any new fiscal policies, the country's increase in fiscal spending places it second only to the US among the OECD economies in terms of its fiscal stimulus as a proportion of gross domestic product.

CYCLICAL AND DISCRETIONARY CONTRIBUTIONS TO FISCAL STIMULUS



Note: The impact of the economic cycle is derived from the sum of the cyclical components of fiscal balances over the period 2008-2010.
Sources: OECD, DB Global Markets Research

In short, the overall response of European government spending (as a proportion of GDP) has been comparable to the other major developed economies of the world. In Europe, fiscal stimulus (both through specific new measures and via the welfare nets to which we refer above) explains partly why consumer confidence and consumer spending have been relatively resilient during the downturn of the last two years. Put simply, households have not had as much to fear from unemployment as their US and UK counterparts have, and their spending patterns are less susceptible therefore to the vagaries of the broader changes in economic conditions.

Household balance sheet strength

Another factor in the resilience of European consumers is the relative frugality they practised in the years before the global credit crisis occurred. There are obvious exceptions to this observation; the UK, Ireland and Spain are all tackling legacies of excessive personal debt accumulation in their economies. However, unlike their peers in the US and the UK, European households generally did not enter the crisis with enormous debt burdens.

Furthermore, European consumers have never made the contribution to economic output that their counterparts in the US and the UK have made. When the credit crisis began and economic activity began to slow around the world, Europe was vulnerable to the weakening of global trade and to a fall in its exports. However, its lesser dependency on the consumer for the overall wellbeing of its economies has provided some buffer against the effects of the credit 'crunch' on consumers elsewhere.

Recovering export markets

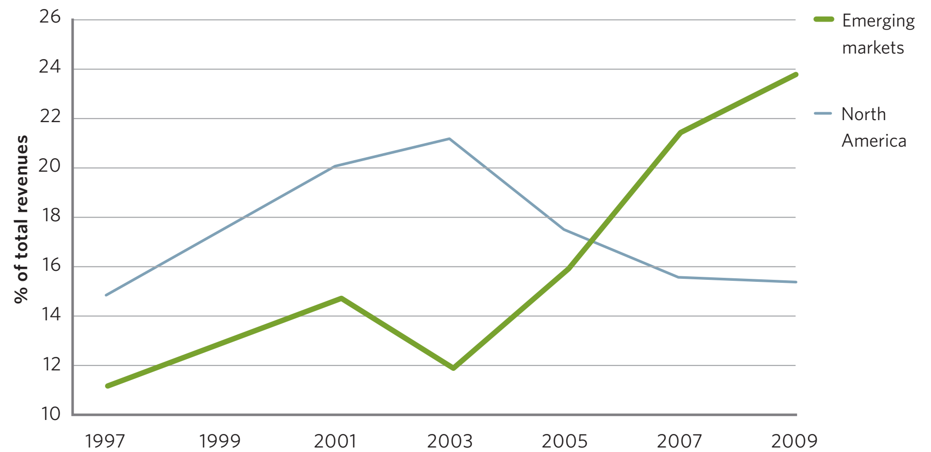
As economic activity slowed around the world during 2008 and 2009, Europe's dependence on export activity had been unfavourable given the slowing of demand beyond its frontiers, particularly in relation to Asia and the emerging markets of the world such as Brazil, Russia, India and China (the 'BRIC' countries).

Latterly, however, a marked increase in exports, which has owed much to escalating demand from Asia and a number of emerging markets amid a faster-than-expected recovery in those regions, has been beneficial to European economies. Corporate restocking, carried out in part in response to that improving export activity, has also supported overall economic growth.

A positive outlook: *developing economies* and *global realignment* themes

We remain cautiously optimistic on the growth outlook for Europe as a whole, but recovery is likely to be uneven across the varying economies of Europe. The key positive is Europe's exposure to global growth, which has allowed it to take advantage of recovering demand in faster-growing regions of the world via improving exports, should stand it in good stead as those regions continue to make progress. The significance of European exporters' exposure to emerging-market demand is often overlooked, with gloominess tending to focus disproportionately on the effect of flagging demand in Europe's more developed export markets. Germany, with the equivalent of about $1.5 trillion of exports per annum, is a particular beneficiary of demand from emerging markets, being the world's second largest exporter (having been overtaken by China during the first half of 2009). Overall, European exporters' sales in emerging markets are now 60% greater than those to the United States.

EUROPEAN EXPORTERS' SALES TO EMERGING MARKETS VS. THOSE TO THE UNITED STATES



Source: Morgan Stanley, September 2009

A positive outlook: *more government* and *construction & reconstruction* themes

In aggregate, the fiscal stimulus measures taken by Europe's governments are modest but it is worth noting that they are actually likely to make a greater impact in 2010 than they did in 2009. Government spending on civil works takes a long time to plan, prepare and commence. Some analysts suggest that less than half of planned fiscal spending took place during 2009, owing to delays in the commencement of infrastructure projects. This will clearly help construction and building materials companies during 2010.

Consumption

Pessimists about Europe's economic prospects often point to sluggish consumption in the region. However, as we observed above, consumption has never been as important to economic growth in Europe as in, for example, the US and the UK. There are even reasons to be positive about the outlook for European consumers. In particular, the threat that rising unemployment will hamper consumer activity is tempered in Europe by the generous welfare arrangements which soften the transition from employment to unemployment.

Earnings

The outlook for European corporate earnings is also (selectively) positive. It is notable in general that Europe's companies did not reduce headcount as drastically as their counterparts in some other regions, most obviously in the US. This owed much to the existence of labour-supportive government schemes, but was attributable also to the structural inflexibility of Europe's employment market (and to the relative cultural sanctity of employment in Europe). It meant that profitability fell more heavily during the economic downturn; but it should mean, in turn, that earnings rise more sharply as revenues begin to recover than in regions where employment was cut aggressively.

Tensions

It is likely that as we go through 2010, there is a risk that tensions will start to escalate, both within Europe and between Europe and other regions. However, it is important to keep these risks in perspective. We address below four areas that are commonly seen to represent threats to Europe's economic wellbeing: the fate of the European banking sector, Central and Eastern Europe, the strength of the euro and the relative fortunes of the core of the eurozone versus the periphery. We believe that only the last two of these four represent material risks for investors in European equities.

The European banking sector

The International Monetary Fund said in September 2009 that European banks have only recognised 40% of the €530bn losses they expect to be realised by the end of 2010. However, European equity investors should keep in mind that many of the losses to which the IMF refers will derive from the non-quoted banks, particularly the German Landesbanken, the Spanish mutual Cajas (or 'caixas') and the Popolare banks and mutual organisations of Italy.

The German Landesbanken have experienced significant losses as a result of their exposure to 'toxic' mortgage-related debt. The Landesbanken used to have an implicit state guarantee of their activities. The European Commission outlawed this guarantee in 2005 but, before the removal of the guarantee took effect, the Landesbanken acquired large amounts of high-yielding, but supposedly 'AAA'-rated, debt in markets such as the US residential mortgage-backed security market. As a consequence of the crisis in those markets, the balance sheets of the Landesbanken have become weak and their ability to fulfil their traditional domestically orientated functions has been severely hampered.

In the quoted European banking sector, by comparison, institutions have made good progress in shoring up their balance sheets via rights issues. With the 'deleveraging' of the quoted banks gradually taking place, the scope for the banking sector to damage the fortunes of equity investors has diminished. Furthermore, with corporate bond issuance in Europe booming, larger European companies should have good access to funding even if bank lending remains constrained. With small companies still struggling to secure funding, there will be a headwind to economic activity, but there should also be opportunities for large companies to make profitable acquisitions of smaller competitors or simply to gain revenues and market share from those smaller peers. These ideas are captured by Newton's *large-cap laggards* theme.

Indeed, the biggest headwinds for Europe's quoted banks are likely to be lack of growth (as they try to 'deleverage' and as customers reduce their appetite for borrowing) and new regulations, which are likely to limit returns in the years ahead. As banks recover, governments are increasingly likely to make use of windfall taxes. The newly elected Greek government swiftly imposed a windfall tax on the banks, indicating how tempting it will be for politicians to raid the financial sector as they attempt to patch up big fiscal deficits.

Central and Eastern Europe

Central and Eastern European nations have been cited collectively by some commentators as a key area of risk for Europe as a whole, but Eastern and Central Europe are now less likely to implode than it seemed they were in the spring of 2009. Back then, there was great concern about the fate of a number of economies, including those of Latvia, Ukraine, Bulgaria and Romania; a devaluation of Latvia's currency (the lat) appeared to be a particularly serious risk, even though the economies of the Baltic region account for less than 1% of global GDP.

However, strong policy actions from the European Union, the European Central Bank, the European Investment Bank and the International Monetary Fund, as well as the passing of the worst elements of the financial crisis, have provided the most beleaguered countries with enough liquidity (and time) to work through their challenges.

Some countries in the region, such as Poland and the Czech Republic, could, in fact, be regarded as enjoying a more stable financial backdrop than some of their western European peers (such as Greece and Spain). With most Central and Eastern European countries having floating exchange rates, their travails are largely reflected in their currencies. The Hungarian florint, for example, reflects many of the challenges that the Hungarian economy faces, but its floating nature should mean that it does not represent a 'stick of dynamite' in the outlook for the region. 2010 is likely to be another difficult year for the Central and Eastern European economies, but their superior growth should resume from 2011 onwards.

Russia has been regarded as a particular area of risk, with its over-indebtedness, its overconfidence in marching into South Ossetia in August 2008 and its unpredictable regard for overseas investors' rights being seen to be key causes of weakness in both the Russian stock market and the rouble. However, Russia has some of the largest stores of foreign-exchange reserves and oil and gas reserves in the world. Following weakness in share prices, investors are now being rewarded more handsomely for investment in Russian equities. A discriminating approach to investment in Russian companies is imperative, but the case for such investment has strengthened during 2009.

A strong euro

While a strong euro may be interpreted as a sign of Europe's economic strength (and may be effective in raising general living standards), a highly valued currency can be a thorn in the side of exporters; hence the regular peppering of ECB President Trichet's pronouncements with references to the 'brutality' of exchange-rate movements. With Asian countries trying to hold down the value of their currencies to maintain competitiveness in their economies, the euro has acted as a 'safety valve' in foreign-exchange markets, appreciating against most major currencies.

A stronger currency need not be detrimental to exporters' fortunes. Manufacturers in countries such as Germany, which are nearer the 'top' of production chains than the 'bottom', need not suffer necessarily from the steady appreciation of their base currencies; German businesses have prospered from their export activities for decades despite euro (and previously deutschmark) strength. Eventually, however, excessive euro strength may result in increased tensions within Europe and internationally, particularly if Asian authorities continue to act to curb the rise of their own currencies.

Core versus periphery

Further tension may derive from discord about the requirement for tighter monetary policy in the eurozone. A German recovery may put pressure on the ECB to raise rates in the second half of 2010; the eurozone economy as whole is forecast[2] to grow by 1.2% in 2010, but German economic strength may spawn a faster expansion. Higher interest rates would be anathema to countries like Ireland, Spain and Greece (for which higher rates would threaten already-fragile domestic activity), but they might be popular among German authorities, in whose minds an aversion to inflation-stirring excess and the fear of social destabilisation tend to be uppermost.

It is also possible that Germany's patience with Ireland, Spain and Greece, for example, may wear thin if the Germans perceive those other nations to be dragging their feet in tackling structural problems. Tensions are likely to arise especially in relation to public-spending deficit tackling (with Germany committed apparently to balancing its budget deficit by 2016, but other countries being content to keep up their spendthrift ways).

Countries like Greece, Ireland, Spain and even Italy have steadily been losing competitiveness for many years with a rising euro, rising wages and poor productivity gains. In an interesting twist of fortunes, it is widely accepted now that Poland and the Czech Republic are better run and more competitive economies with less sovereign and macroeconomic risk than these peripheral eurozone countries.

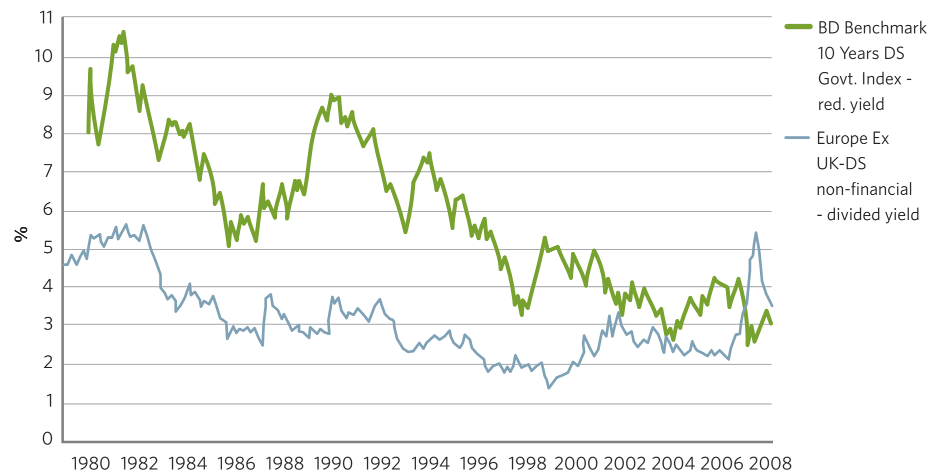
Equity investors will need to take account of such risks and, in bond markets, investors should be mindful that yield differentials between government issuers may widen quickly if strains build. If tensions are resurgent between European countries, an investment strategy that favours the 'core' economies and markets may well be preferable to one that seeks to exploit opportunities in the 'peripheral' nations.

Balancing opportunities and risks

The policy response of governments and the central banks in Europe has been unprecedented in scale, export activity should continue to improve, and European consumers should prove to be more robust than is widely expected. With Europe's monetary policymakers explicit about their intention to maintain 'loose' policy for the time being, and with interest rates offering little solace to yield-hungry investors, share prices may well strengthen further during 2010 (albeit that mounting tensions later in the year may mean that gains occur predominantly in the first half of the year). The dividend yield on European equities looks very attractive compared with government bond yields (and certainly with short-term cash rates as well).

2 Source: the Economist poll, November 2009

EUROPEAN EQUITY MARKET YIELD VS. GOVERNMENT BOND YIELD



Source: Thomson Reuters Datastream as at 23.11.2009.

The relatively high ‘operational leverage’ of European companies (given that those companies are less equipped to reduce costs as aggressively as their counterparts in some other regions) entails greater volatility in European corporate earnings. In Europe, employment levels tend to be constant but profits are highly variable; in the US, by comparison, profitability tends to remain fairly constant given that employment levels are highly variable. During a downturn, European companies’ high operational leverage means that earnings fall faster than in the US. However, during a recovery, such leverage should allow European businesses to grow their profits highly effectively, not least too because the fact that they tend to keep productive capacity intact during periods of economic weakness allows them to respond quickly to improving demand during economic recovery. By contrast, some US companies are incurring costs in recruiting employees at present to bridge the gap left by previous lay-offs and to enable them to respond to more favourable conditions.

We believe that 2010 returns will be better in the core rather than the periphery of the eurozone. We believe large-cap stocks will outperform small-cap stocks markedly in Europe. A supportive monetary framework with very low interest rates will trigger a hunt for yield, and there are many European blue chip companies whose equity yield is far in excess of the yield on their own corporate bonds.

Over the longer term, challenges in the aftermath of the global credit crisis are likely to affect corporate prospects for some time in Europe (and elsewhere), but the region’s globally diversified, ‘blue chip’ companies should be well-placed to benefit nonetheless from economic improvement in the faster-growing areas of the world. There are significant opportunities available to the discerning investor in European equities.

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