

The view from

# Europe

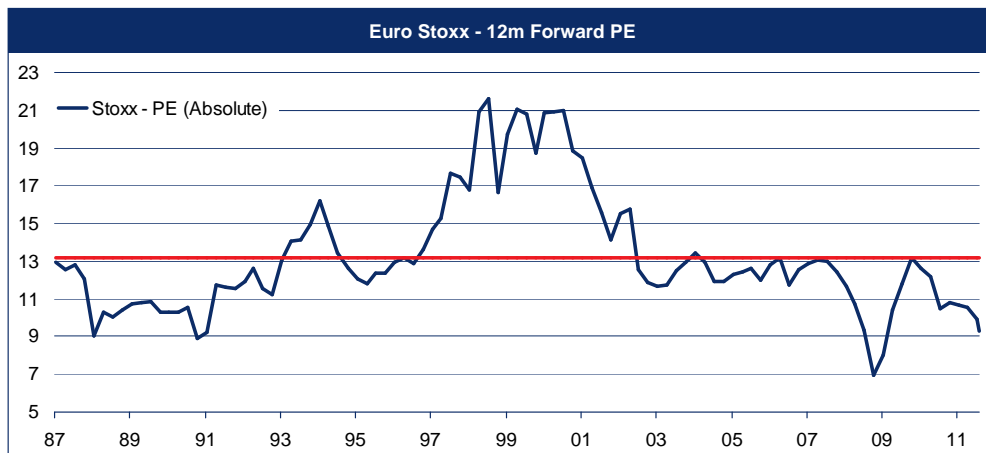
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Seasonal volatility has become par for the course over the summer months. The last few weeks have been no exception as that most unpredictable factor – human behaviour – has shaped market direction. First, it played out in the national interests of the various eurozone countries as they struggled to agree a combined policy stance to the problems facing heavily indebted nations. Although a stop-gap solution appeared to have been reached, markets remained fractious as similar concerns about borrowing levels resurfaced across the Atlantic. Again, a last-minute agreement within the US Congress allowed the US to raise its borrowing limit but the markets have been far from impressed, not least because a downgrade from S&P followed and this has reignited concerns surrounding the fragility of the global economy.

Listed below are our thoughts on why European equities remain attractive, despite the latest concerns.

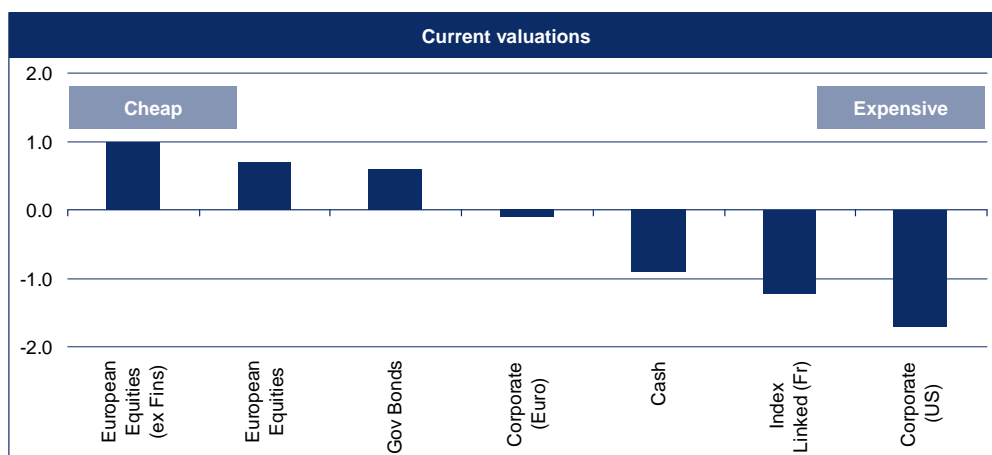
**Valuation** – Europe is cheap versus other regions, historical levels and other asset classes. Valuations have been low for some time but the charts below highlight the extremes we have reached with recent moves:

## 1) European equities on a forward price-to-earnings



Source: Henderson Global Investors, Citigroup Global Markets, DataStream as at 4 August 2011

## 2) European equities versus other assets classes. This chart looks at how many standard deviations key asset classes are trading away from their 10 year average yield levels. Once again European equities are cheapest.



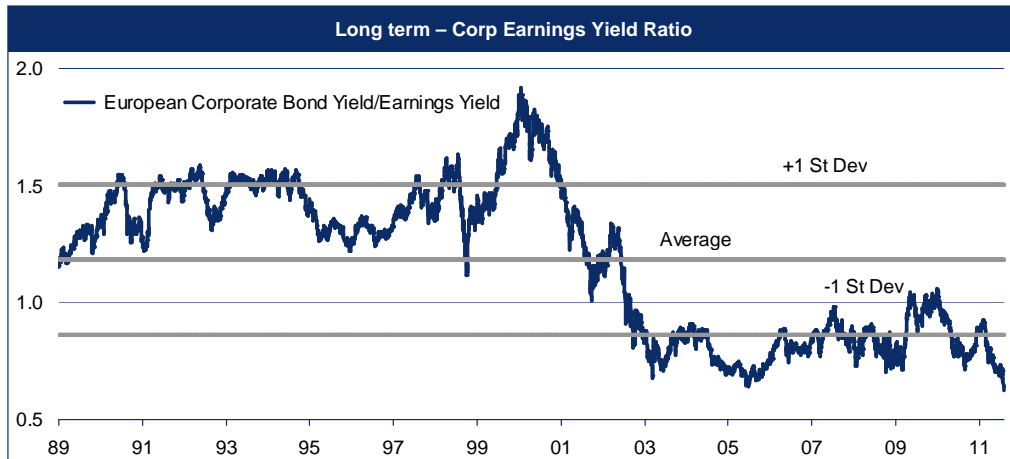
Source: Henderson Global Investors, Citigroup Global Markets, DataStream as at 4 August 2011

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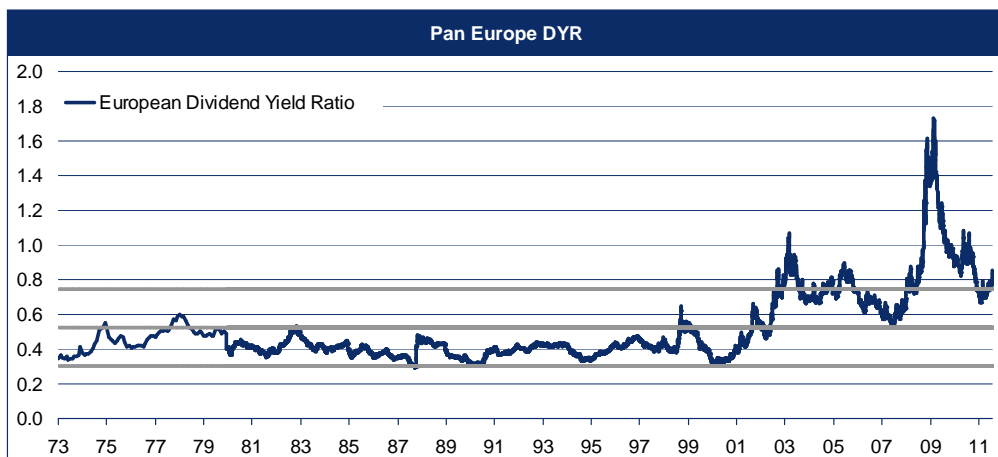
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- 3) This looks at the divergence in valuation between bonds and equities. Rarely have equities been so cheap versus bonds.



Source: Henderson Global Investors, Citigroup Global Markets, DataStream as at 4 August 2011



Source: Henderson Global Investors, Citigroup Global Markets, DataStream as at 4 August 2011  
Note: Dividend yield divided by govt bond yield

Since compiling these charts the valuations have moved even further. The Euro Stoxx now trades on 8.7x forward earnings and the implied equity risk premium is 7.9%, higher than in March 2009. When valuations have reached these extreme levels in the past it has produced good returns to buy and hold them for the long term.

**Earnings season** – Second quarter earnings generally showed some positive trends but some stocks were disappointing (beat to miss ratio is approximately 50%). Many of the misses were a result of currency movements and higher input costs. The quality companies with pricing power will be able to pass these costs on to their consumers but this takes time and there is often a lag of a few quarters when this takes place. We have also seen the price of these raw materials fall dramatically in recent weeks. From their highs earlier in the year oil (-27%), copper (-12%) and aluminium (-12%) have all fallen dramatically.

The strength of the Swiss Franc was a drag for a number of stocks. The use of the currency as a safe haven has pushed the Franc to extremely overbought levels. The Swiss government have been undertaking measures to stop further appreciation and once risk appetite returns we should see a reversal in this trend.

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**There are some key differences between now and when Lehman went bust** – First, and most importantly, corporates are in much better condition. In 2008 many companies had highly leveraged balance sheets. Since that time companies have been through a phase of deleveraging that has left many with very high cash balances (which some are now using to buy back their own shares – i.e. company management see value in their share prices) and average net-debt-to-EBITDA close to ten year lows. In addition the banking system now has access to liquidity lines created by governments and central banks during the crisis. This means it is unlikely that we see corporates suffer from a liquidity freeze like the one we saw in 2008.

## So where do we go from here?

The short term outlook for equity markets is uncertain. The stalling of Europe's politicians and the brinkmanship by the politicians in the USA is alarming. Their indecisiveness has clearly influenced economies and is showing in the latest economic indicators. This has led to a great deal of panic and the sharp sell-off in risk assets. When the market enters panic mode and company fundamentals are ignored (the good stocks have been sold off just as much as the bad) it is hard to determine when cheap valuations will assert themselves and we see a rebound.

Encouragingly we are beginning to see some tentative signs of better economic data and policy response. On the growth front over the last week, we have seen positive surprises in initial jobless claims, non-farm payrolls, German manufacturing orders and European services PMIs. We have also seen action from policy makers, the FOMC announced it will keep rates low for 2 years (and didn't rule out the possibility of further quantitative easing) and the ECB has stepped in to purchase Italian and Spanish bonds helping to push down spreads in Peripheral Eurozone. Clearly politicians on both sides of the Atlantic have more to do but the pressure applied by the market appears to be forcing them into action. Ultimately this could be a good thing and we will be keenly following what we hear from the Jackson Hole symposium (Aug 26) and from Europe's politicians (Sarkozy and Merkel are due to meet in Paris on Tuesday). The market is not currently giving politicians the benefit of the doubt and given their form we believe this conservative approach is appropriate.

The result, and a scenario we have positioned ourselves for, is that we are in a period of low growth in developed economies. Analysts need to recalibrate their models inline with this scenario but ultimately this can be a good environment for equity returns. Stock picking in this low growth environment becomes very important and should leave us well placed to deal with bouts of risk aversion that have become the norm.

**Henderson European Equity Team, 12 August 2011**

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