Invesco 景順

Market Insights

Opportunities in European equities

April 2014

"Investors are going to increasingly focus on earnings improvements, and Europe is in a good position to deliver them, given the deep recession it has been through."

Key concerns about Europe are misguided

Despite the gloomy clouds as a result of the Russia-Ukraine political unrest, European equities managed to edge higher in the first quarter of this year as macroeconomic data continued to show an improving trend, while inflation continued to nudge lower. Although some investors remain skeptical about the economic outlook for Europe, we believe that macro-economic fears about the region are overblown and that investors' major fears for the continent are not justified. This, coupled with compelling valuations, makes us believe that shrewd investors cannot afford to miss the opportunities currently available.

Falling energy prices actually help

Most of the fears around Europe center on concerns about deflation and the annual rate of inflation as measured by the consumer price index (CPI) fell from 0.7% in February, to 0.5% in March, a touch below the consensus expectation of 0.6%. The main driver of the fall was a decline in core inflation from 1.0% to 0.8% and this drop reversed the previous month's rise leaving the annual rate, once again, close to its record low of 0.7%. However, we do not think that deflation is a real threat, primarily given that as much as 70% of the headline decline in inflation was attributable to falling energy prices and food prices, which are not typically signs of troubling deflationary trends—in fact, in the case of energy prices this can actually help an economy.

Business confidence continues to improve

We see evidence of an increase in business confidence in Europe. The increase in the EC Economic Sentiment Indicator index (ESI), from 101.2 to 102.4, was better than expected (consensus was 101.5) and suggests that businesses and consumers have shrugged off recent tensions in Crimea. In our view, the rise reflected a broad-based improvement in sentiment across various sectors. Consumer sentiment also staged a strong gain, reflecting a significant improvement in households' assessment of the overall economic outlook. In addition, there has been an uptick in corporate investment underway as companies are reaching the point where it may be more expensive for them not to invest. As a result, we expect to see a pick-up in capital expenditure in some areas.

Invesco 景順

Market Insights
Opportunities in European equities

April 2014

Amid improving economic data in key European countries, investors should not be too pessimistic about the situation in peripheral countries. Taking Spain as an example: youth unemployment in the country is not as dire as perceived. While headline figures may reach 50%, these numbers include young people in university and other education, and the real number is closer to 25% which, while still very high, is much lower than many of the other figures bandied about. There has been a great deal of structural reforms, even in the peripheral countries, with the labor market reform in particular.

A strong euro is not a threat

One of the headwinds for the European continent has been a strong currency, but this is likely to change over the next year or so. The euro has been stronger than people expected, but investors should examine whether it has been driven by eurozone factors or those from elsewhere. We expect the US dollar to strengthen over time, particularly because of interest rate rises and the fact that differentials will favor the US dollar over the euro. A strong euro is not something that we are worried about, and we believe that Europe is going through the "growth" stage of an economic cycle, having passed through the "panic" and "hope" stages.

This means that investors are going to increasingly focus on earnings improvements, and Europe is in a good position to deliver them, given the deep recession it has been through. Currently, the market is being driven by earnings, and while we are not expecting massive movements in price-to-earnings (P/E) ratios, MSCI Europe is around 20% off the long term P/E (Figure 1), an attractive level. In addition, earnings growth should really start to accelerate with an expected earnings growth rate of 14.6% for 2014[1], a positive sign for the stock market.

Figure 1: Europe overall looks cheap, the peripheral countries even more so
Cycle adjusted P/Es for different geographies

	Current cycle adjusted P/E (x)	Long term average cycle adjusted P/E (x)	Premium/ Discount
US[1]	24.9	22.5	11%
Asia Pacific exc Japan AC[5]	18.2	21.6	-16%
Europe[1]	**16.0**	**19.9**	**-20%**
Germany[1]	18.9	20.3	-7%
UK[1]	15.0	18.4	-18%
Portugal[4]	11.2	15.1	-25%
Spain[2]	11.8	20.0	-41%
Italy[3]	10.5	25.9	-60%

Source: JP Morgan Cazenove, Datastream as at 10 March 2014. [1]Underlying data started from 31 January 1970 for MSCI Europe, MSCI US, MSCI UK and MSCI Germany. [2]Underlying data started from 31 January 1980, MSCI Spain. [3]Underlying data started from 29 April 1984, MSCI Italy. [4]Underlying data started from 31 January 1992, MSCI Portugal. [5]Index captures large and mid-cap representation across four of five developed markets in countries excluding Japan, and eight emerging markets countries in the Asia Pacific region. Underlying data started from 30 November 1995. MSCI index. Current cycle adjusted P/E (x) as at 10 March 2014. All data on a nominal basis. Past performance is not a guide to future returns.

[1] Source: FactSet, I/B/E/S/, MSCI, Goldman Sachs Global Investment Research, consensus estimates for MSCI Europe (USD), as at 4 April 2014.

201403(2253)