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Market Insights
Europe: Monthly Review and Outlook

August 2014

- European equity markets retreated in July
- Corporate earnings have produced a mixed picture
- Macro data progress slow but steady
- In the UK, unemployment fell to 6.5% and Q2 GDP rose on first estimate

Review (covering July 2014)

- European equity markets were impacted in July by continued geo-political uncertainties, mixed corporate earnings results, and the shadow of a renewed debt crisis. Most of continental Europe's stock indices retreated, led by Portugal's PSI All-Share Index which registered the worst performance in the region, dropping 10.5% (in EUR total return terms) in one month. The FTSE World Europe excluding UK Index (in EUR total return terms) fell by 2.7% in July.

- A new set of economic sanctions against Russia were announced by European and American leaders amid increased tensions in Ukraine. These recent coordinated sanctions went beyond previous moves against banking and defence industries, targeting Russia's energy sector and its access to western technology, limiting its capabilities to tap into reserves. The effect of these announcements was felt particularly by the oil & gas sector, which witnessed the most severe drop in value due to its significant links to the Russian market. Among the 10 industry segments of the ICB classification, only technology and healthcare gained ground in July, while all the remaining sectors regressed.

- Meanwhile, European corporate earnings showed a mixed picture during the period under review. On the one hand, encouraging results stemmed from areas most affected by the euro crisis such as financials; Spanish mid-size banks, for example, reported very positive Q2 earnings powered by margin expansions and falling bad debt. On the other hand, concerns remained over global business activity, as a number of international companies lowered their guidance and profit forecasts for 2014.

- In the UK, the FTSE All-Share index edged lower, which meant that the low level of volatility and modest monthly changes in the level of the UK equity market has been maintained. Notwithstanding this, the economic news remains encouraging with the economy continuing to expand with a still relatively low level of inflation.

- In July the preliminary estimate of the UK's gross domestic product (GDP) was released, which showed a quarterly rise of 0.8%. This rise in economic activity had a particular significance as it meant that GDP had risen to a level just above where it was before the recession started in 2008. In addition, the latest unemployment figures were released, which showed a further fall to 6.5%. This rate was the lowest since December 2008. Commentaries suggested that there is still, however, slack in the labour market and this was evidenced by the latest growth rate for average pay, including bonuses, which fell from 0.8% in April to 0.3% in May.

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"Views of our European Equity team based in Henley-on-Thames"

Market outlook

- Regional and international headwinds faced by Europe in the recent months have naturally affected equity markets. Russian-Ukrainian tensions and Italy's weak GDP data exacerbated the effect on stock prices. Mid and Small cap companies were also further impacted from the noticeable selling of European ETFs by US investors during a relatively quiet and little liquid summer season. However, scrutiny of the current situation suggests that the market upset has been somehow sharper that fundamentally warranted in our view.

- On the macro side, we see some encouraging elements, such as falling unemployment, expanding PMIs in so-called 'periphery' countries, and an increasing appetite for credit (as per the latest European Central Bank (ECB) bank lending survey), which should filter down to the rest of the economy. On the micro side, we continue to believe that the playing field for European corporates is good: low inflation (but no deflation), low growth (but not negative) and low interest rates (and lower for longer than in other parts of the world).

- We think that European companies will use this environment to invest in their businesses, employ operating leverage and benefit from growth throughout the world. GDP numbers in China and the US, key drivers for European corporate earnings, are also looking a bit better. This should help margin expansions and allow valuations to deliver increased share prices, even with a shy European GDP growth. In this period of market weakness, we remain focused on earnings delivery in Europe and look favourably to the upcoming period.

European equities (as at 31 July 2014)

	1 Month	3 Months	6 Months	YTD	2013
FTSE World Europe ex-UK (£)	-3.7%	-4.0%	2.4%	-0.7%	25.2%
MSCI Europe	-1.5%	0.7%	6.9%	5.0%	20.5%
France: CAC 40	-4.0%	-3.4%	4.6%	1.5%	22.2%
Germany: DAX	-4.3%	-2.0%	1.1%	-1.5%	25.5%
Spain: Ibex 35	-1.6%	3.4%	10.1%	10.5%	30.0%
Italy: FTSE MIB	-3.4%	-3.7%	8.1%	10.7%	20.5%
Swiss Market Index (capital returns)	-1.7%	-0.8%	2.7%	2.5%	20.2%
Amsterdam Exchanges	-2.1%	2.1%	6.5%	2.6%	20.7%
HSBC European Smaller Cos ex-UK	-3.7%	-1.9%	4.9%	6.7%	34.0%
MSCI Russia (US$)	-8.4%	8.4%	-3.4%	-13.2%	1.4%
UK: FTSE All-Share	-0.3%	-0.2%	4.5%	1.3%	20.8%
UK: FTSE Small Cap ex Investment Trusts	-0.8%	-2.7%	-3.6%	-0.4%	43.9%

Source: Thomson Reuters Datastream, total returns in local currency unless otherwise stated.
Data as at 31 July 2014.

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