Market Insights
Europe: Monthly Review and Outlook

September 2014

- European equity markets advanced in August
- Draghi hinted at renewed stimulus measures to avert deflation
- Disappointing eurozone GDP figures, but improving corporate earnings overall
- In the UK, the consumer price index fell, while the Q2 trade deficit increased versus the Q1 figure

Review (covering August 2014)

- European equity markets rose in August, registering their first monthly gain since May. Nervousness surrounded equity markets at the start of the month with the escalation of military conflict in Ukraine, disappointing Q2 eurozone GDP figures and an inflation rate close to zero. Markets rebounded in the final half of the month, however, with investors regaining confidence following comments made by Mario Draghi, President of the European Central Bank (ECB). At a symposium in Jackson Hole, Wyoming, drawing central bankers from all over the world, Draghi stated that he is ready to use "all the available instruments needed to ensure price stability", hinting to more stimulus measures by the ECB and the potential announcement of a quantitative easing program.

- On the macro side, economic data remained mixed. Inflation in the eurozone slowed further in August, from 0.5% to 0.3%, the weakest rate since October 2009; unemployment remained constant at 11.5%. GDP figures showed the German economy shrinking by 0.2% in the second quarter, France's stagnating and Italy falling back into recession. Yet, fundamentals remain constructive. Lead indicators still point to expansion in the eurozone, albeit at a slower rate. The fiscal drag in Europe has been significantly alleviated and the economic revival in some peripheral countries is still well on track. In Ireland, the Manufacturing Purchasing Manager's Index reached 57.3 in August, the highest since September 2011. In Spain, latest total mortgage lending figures showed a growth of 13.2% year-on-year, up from a decline of -9.2% in the prior reading. Corporate earnings in Europe have also improved in Q2 and are set to grow in 2014, helped by a pick-up in global economic activity. Despite the latest headwinds, various economic forecasts still imply a strengthening of activity in the eurozone going into 2015.

- In the UK, the FTSE All-Share index rebounded this month, against the background of low market volatility that has continued over recent months. Despite this lacklustre pattern, the quarterly trends of economic data are generally encouraging, although the recently released data for June has seen a bias to more disappointing news. An analysis of the month's primary sector price movements within the equity market shows that the technology hardware sector was amongst the better performers, whereas the mining and food & drug retailers were amongst the worst.

- On the macro front, CPI inflation fell to 1.6% in July from 1.9% in June. This fall was to a level below that of the consensus expectation and could be attributed to a fall in the rate of price inflation for clothing and food. Relatively cheaper consumer products should be helpful for the consumer. Their confidence can be guaged from the retail sales volume figures for July, which rose by 0.5% from the level in June and are now therefore 3.4% higher than a year ago. There is, however, a persistent constraint to higher levels of consumer spending and this comes from the continued weakness in wage growth. The rate of wage growth, excluding bonuses, fell to just 0.6% in June. This is the lowest rate of wage growth for many years and contrasts starkly with the rate of inflation for that same month of 1.9%. This low rate of wage growth has been used by The Bank of England as evidence of slack in the economy. Away from the consumer, industrial production figures for June were released that showed a monthly rise of 0.3% which was below the consensus of expectations. Related to industrial production are the UK's trade figures. Data showed a widening of the trade deficit over Q2 to £6.9bn versus the smaller deficit of £5.5bn for Q1. This deficit has not been helped by the sluggish nature of exports which reflects the depressed state of much of the continental European economies.

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

Market outlook

- Geopolitical concerns and recent softer data have trimmed growth forecasts, but the outlook remains one of modest positive growth, and fundamentals in Europe remain constructive in our view. Equity valuations are still at a discount compared to historical averages, especially for countries and sectors most affected by the euro-crisis, such as the periphery (e.g Spain, Italy, Ireland) and financials. Domestic demand is finally starting to pick up, while remaining a long way below pre-crisis heights.

- During August, small caps underperformed larger caps in Europe, impacted by Q2 GDP readings. However, despite softer economic figures and continued geo-political tensions, European markets were able to absorb headwinds better than any time in the recent years.

- The process of bank de-leveraging, which placed significant burden on lending activity, is now in its final stages, and ECB monetary policies continue to be supportive with further easing announced during the last governing council meeting. Growth outside of Europe is also set to strengthen after a weak 2014 first half, providing some support for European industries. We believe that all these factors ought to spur European market recovery, and offer interesting prospects among small cap companies in Europe. In the large cap universe, we continue to favour more cyclical industries while underweighting defensives, where we see less appealing risk/reward profiles at the present time.

European equities (as at 31 August 2014)

	1 Month	3 Months	6 Months	YTD	2013
FTSE World Europe ex-UK (£)	2.1%	-3.9%	-0.8%	1.5%	25.2%
MSCI Europe	2.0%	0.0%	4.0%	7.1%	20.5%
France: CAC 40	3.2%	-2.5%	2.0%	4.7%	22.2%
Germany: DAX	0.7%	-4.8%	-2.3%	-0.9%	25.5%
Spain: Ibex 35	0.6%	0.4%	8.2%	11.1%	30.0%
Italy: FTSE MIB	-0.6%	-5.0%	2.1%	10.0%	20.5%
Swiss Market Index (capital returns)	3.0%	-0.2%	2.2%	5.6%	20.2%
Amsterdam Exchanges	2.7%	2.0%	5.9%	5.4%	20.7%
HSBC European Smaller Cos ex-UK	0.7%	-3.5%	-0.5%	7.4%	34.0%
MSCI Russia (US$)	-1.5%	-4.8%	-2.5%	-14.5%	1.4%
UK: FTSE All-Share	2.2%	0.6%	1.4%	3.5%	20.8%
UK: FTSE Small Cap ex Investment Trusts	1.3%	-0.9%	-5.1%	0.9%	43.9%

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

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