

Schroders Outlook



2014: European Equities

Rory Bateman, Head of UK and European Equity



The STARS are aligned

- **Supportive macro environment.** The European economy has troughed and we are expecting positive GDP and positive earnings revisions from here
- **Tapering in the US** should have a minimal impact on European stocks but will be detrimental to emerging and US markets
- **Asset quality review.** We believe the AQR will restore confidence in the European banking system and put to rest fears of a eurozone banking crisis
- **Risk premium in Europe** is still at elevated levels despite the market appreciation. Valuation of European equities remains compelling versus history and other equity markets around the world
- **Stock selection** is critical now that correlations have normalised. Our preferred sector is consumer cyclical where we see the greatest upgrade potential.

“There is still plenty of upside potential in Europe in terms of profit margin expansion”

Europe's economy has stabilised and political risks have diminished. Equities enjoyed gains in 2013 as the risk of a eurozone break-up receded, yet valuations remain compelling and there is still plenty of upside. The next catalyst should be an improvement in earnings momentum, and a stock-picking approach will be needed to identify the winners.

Supportive macroeconomic environment in Europe

The eurozone has now registered two successive quarters of growth and even the troubled peripheral economies are showing positive signals. Progress is likely to remain slow but the economy has stabilised and leading indicators are pointing in the right direction. We are encouraged by the convergence of unit labour costs across the eurozone, with Spain and Portugal coming down towards German levels. Another area starting to show convergence is borrowing costs. Corporates based in the periphery of Europe are still paying more to borrow than their German counterparts but the gap is narrowing.

On the negative side, unemployment rates remain at extremely elevated levels in some parts of the eurozone. We anticipate that the German government, once a coalition is formed, will be proactive in addressing the unacceptably high youth unemployment rates in places such as Greece and Spain.

Tapering in the US will have a minimal impact on Europe

One of the main risks facing the global economy in 2014 will be the US Federal Reserve's tapering of its quantitative easing programme. Europe is likely to be relatively unaffected by this. Tapering will lead to the strengthening of the US dollar and will see the euro become relatively weaker, which will be a positive for Europe's exporters. By contrast, emerging markets are likely to be negatively impacted by tapering, dollar strength and a reversal of yield chasing hot money flows.

Monetary policy remains loose in Europe and the European Central Bank (ECB) has demonstrated that it is prepared to act decisively. Recent lower-than-expected inflation has seen the ECB cut rates, but that is just one policy available. We note that, compared to other central banks, the ECB has a number of unused tools on hand to combat the risks of low growth and weak inflation.

AQR to demonstrate that the European banking sector is investible

The risk of a European systemic banking crisis has virtually disappeared. The region's banks have been unwinding and de-risking their balance sheets, and issuing equity. The sector is on course to have a Basel III Core Tier 1 ratio of 10% by the end of 2013 – well ahead of the timeframe required by the regulator. The ECB will carry out its Asset Quality Review in 2014. Certain individual banks are likely to need extra capital, but overall we anticipate that the exercise will restore confidence and show that Europe's banks no longer pose a systemic risk.



Schroders



Rory Bateman
Head of UK and European Equity

Rory Bateman joined Schroders in April 2008 and is Head of UK and European Equity. His responsibilities include managing Pan European Equity portfolios, including Schroder ISF* European Equity Focus and Schroder ISF European Large Cap, and management of the other portfolio managers and European research analysts.

Prior to joining Schroders, Rory spent 12 years at Goldman Sachs Asset Management where he was the portfolio manager for Continental European Equities for 8 years. In addition, Rory has 12 years' experience as an analyst covering numerous sectors across the European market.

Spanish banks face challenges regarding their exposure to real estate developer loans while Italian banks face some uncertainty around non-performing loans. Nonetheless, 80% of the banking sector by market capitalisation lies outside the periphery. Banks will not regain the 25% return on equity (ROE) that we saw before the financial crisis but a 15% ROE is a very real proposition. With good quality European banks available for around 0.7 times book value, that is a very compelling valuation opportunity.

Risk premium still elevated, but coming down

European equities have enjoyed a re-rating recently. However, those gains were largely driven by the European equity risk premium (ERP) coming down from all-time highs as the prospect of a eurozone break-up receded. The ERP remains above its average historic level and normalisation should drive further gains. Moreover, European shares remain good value relative to their own history and when compared to their US and Asian counterparts.

The next catalyst for European equities should be an improvement in earnings momentum. European earnings are still some 30% below their peak, while US earnings have already surpassed their previous peak. We see scope for domestic European earnings to recover in 2014 as economies return to growth and activity picks up. There is still plenty of upside potential in Europe in terms of profit margin expansion.

Stock selection is crucial

The concerns over a eurozone break-up have seen investors favour the quality global growth exposure offered by sectors such as food & beverages. However, as the economic backdrop improves those defensive sectors have become expensive and we are now seeing more opportunities in value. With consumers spending more, the consumer cyclicals space is of particular interest to us. In our view, this is the area where earnings upgrades will come through in the next 18 months. Regionally, Germany's DAX is trading at all-time highs but it is a different story in the periphery. Spain's Ibex 35 and Italy's FTSE MIB are trading well below their 2007 peaks and valuations in these markets are very attractive.

During the nadir of the eurozone debt crisis in 2011/12, it did not matter what you owned in Europe: equities were sold off indiscriminately. This trend has now abated. Correlations are now much closer to normalised levels and set to reduce further as the eurozone economy stabilises and grows. It is our view that the focus has to be on understanding the shades of grey within the European market, rather than on making big country or sector calls. The European market in 2014 will be one for stock-pickers.

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*Schroder International Selection Fund is referred to as Schroder ISF throughout this document.