“Slow and Steady Wins the Race”

European equity investors may be forgiven for believing that they are suffering from crisis fatigue. They have endured the eurozone’s problems for a number of years and, due to the incomplete structures of the single currency, these difficulties will not be resolved quickly. However, the growth outlook for Europe is clearly improving. Indeed, there are a number of reasons why we are cautiously optimistic as we move into 2014.

Firstly, and most importantly, the European Central Bank (ECB) has demonstrated its willingness to act as a backstop, or safety net. Thus, Mario Draghi has provided leadership by:

- Launching the Long-Term Refinancing Operation, enabling the ECB to provide financing to eurozone banks;
- Backstopping government bond markets, when they have needed assistance; and
- Cutting rates to combat low inflation.

These actions demonstrate that, when necessary, the eurozone’s institutions will take the measures required to maintain the single currency and support the member economies.

Secondly, leading indicators are recovering and we believe this will result in improved GDP and earnings growth in 2014. As Figure 1 demonstrates, business confidence has also revived.

Figure 1: European earnings growth and business confidence

European growth should also benefit as the drag on GDP caused by austerity measures starts to come to an end. Analysis from UBS shows that the fiscal drag resulting from austerity will fall to close to zero in 2014 and 2015, from around 1.5% in 2012 and 0.7% in 2013. Interestingly, this is considerably less than in the UK, which is experiencing a continuing annual fiscal drag of between 0.5% and 1.0%, and yet is enjoying a healthy recovery.

Source: Barclays Research, DataStream, October 2013.
Definitions: The European business confidence numbers are based on the Economic Sentiment Indicator (ESI) survey from the European Commission. Earnings growth numbers are based on the DataStream Developed Europe Total Market Index, which includes the c. 2000 largest stocks in Europe.
The improvement in Europe has been taking place at a time when emerging market growth expectations have been revised downwards and a political impasse has affected the US. We expect that the improvement in European growth prospects will account for the lion’s share of the change in global growth expectations for 2014 and 2015 (figure 2).

**Figure 2: Contribution to change in global growth over the next two years, IMF forecasts**

Equity risk premium
Another positive factor for European equities is that the equity risk premium (ERP) remains at a high level, but is falling. A high ERP reflects a relatively high return demanded by investors to balance the perceived risk of equity ownership. As tail risks recede and growth recovers, the ERP will fall and equity investors will become more confident about buying equities, thus driving up markets. Indeed, this phenomenon is already evident in the increased buying of European equities by US investors, following a five-year absence.

European earnings have lagged the US
It is worth noting that the European corporate sector has suffered from the weak macroeconomic background. European earnings remain 20% below their previous peak whilst US earnings are now 14% above their pre-crisis highs. Much of this is down to margins, which have lagged significantly in Europe (figure 3). In an improving European economic environment, we expect this gap to narrow.

**Figure 3: Profit margins in the US and Europe**

Source: Deutsche Bank, IMF, 30 September 2013.

Source: Barclays Research, Datastream, November 2013.
What does this mean for equity markets?

Traditionally, following a cyclical trough in Purchasing Managers' Indices (PMIs), equity markets tend to re-rate ahead of a recovery in earnings. This factor lies behind the recent rise in the European market, which has experienced in excess of a 40% re-rating over the past 18 months, despite falling earnings. This type of reaction is far from unusual and Figure 4 shows that in the past, such a re-rating has been followed by a period of flat PE ratios as earnings improve. We believe this is the situation we are now in and that the recent re-rating will be followed by an improvement in earnings.

Figure 4: European forward P/E multiples and EPS from previous P/E troughs (1990, 2003 and 2008) – indexed to 100

![Graph showing European forward P/E multiples and EPS from previous P/E troughs](image)


We have recently upgraded our earnings expectations for Europe (ex.UK) to 5% for 2013 and 10% for 2014. These are certainly not high earnings growth forecasts, but contrast starkly with recent downgrades and should present a more attractive environment for investors. Monetary easing in Europe, combined with rising earnings, should contrast positively with the impact of a tapering of quantitative easing in the US, and the resultant pressure on emerging markets.

Where to invest?

So, where is earnings growth likely to be strongest? Domestic European sectors should lead the way and we have recently found strong equity stories in areas such as media and recruitment, which tend to be local or regional businesses. Figure 5 illustrates how earnings momentum in domestically-oriented European stocks has increased in recent months.

Figure 5: Estimates of earnings momentum at stocks with domestic European exposure

![Graph showing estimates of earnings momentum at stocks with domestic European exposure](image)

Source: Redburn, November 2013.
In addition, whilst financial sectors face numerous challenges, it is in the interest of European governments and regulators to ensure that banks continue to lend to the real economy. The ECB, in its role as banking supervisor, is conducting stress tests on the eurozone’s banks and the results will be known next year. It is notable that a number of banks (e.g. Unicredit, Banco Popular, Banco Sabadell, Bankia, Commerzbank and Deutsche Bank) have recently raised equity to bolster their balance sheets. The upcoming stress tests – considered by some analysts to be ‘a stealth recapitalisation programme’ by the ECB – probably prompted this development. Consequently, we believe that the stress tests, rather than creating a new problem, will form part of the solution to the banking sector’s difficulties. Thus, we have added, selectively, to our holdings in eurozone banks.

Valuations
Another factor in Europe’s favour is that markets remain attractively valued. Whilst we are some way off the lows of 2009, the cyclically-adjusted PE for Europe remains attractive in historical terms (figure 6). With GDP improving and earnings expected to recover, the environment is attractive both from an asset allocation standpoint, and in terms of stock picking.

Figure 6: Cyclically-adjusted price earnings valuations

Conclusion
We have previously argued that we should not expect to see explosive growth in Europe or the eurozone and this remains true. However, as long as the eurozone remains intact, Europe offers good potential to long-term investors. The ECB has shown its willingness to take the measures required to maintain the single currency and support the eurozone economy, while Europe’s politicians want to ensure that no further crises occur. ‘Slow and steady wins the race’¹ and an environment with fewer shocks than has been the case recently should prove positive for European equity markets as we enter 2014.

¹: ‘Slow and steady wins the race’ – quote from Aesop, author of Aesop’s Fables including The Hare and the Tortoise, 620-560 BC.
IMPORTANT INFORMATION: FOR USE BY INVESTMENT PROFESSIONALS ONLY (NOT TO BE PASSED ON TO ANY THIRD PARTY). PAST PERFORMANCE IS NOT A GUIDE TO FUTURE PERFORMANCE. THE VALUE OF INVESTMENTS AND ANY INCOME IS NOT GUARANTEED AND CAN GO DOWN AS WELL AS UP AND MAY BE AFFECTED BY EXCHANGE RATE FLUCTUATIONS. THIS MEANS THAT AN INVESTOR MAY NOT GET BACK THE AMOUNT INVESTED. THE RESEARCH AND ANALYSIS INCLUDED IN THIS DOCUMENT HAS BEEN PRODUCED BY THREADNEEDLE INVESTMENTS FOR ITS OWN INVESTMENT MANAGEMENT ACTIVITIES, MAY HAVE BEEN ACTED UPON PRIOR TO PUBLICATION AND IS MADE AVAILABLE HERE INCIDENTALY. ANY OPINIONS EXPRESSED ARE MADE AS AT THE DATE OF PUBLICATION BUT ARE SUBJECT TO CHANGE WITHOUT NOTICE. INFORMATION OBTAINED FROM EXTERNAL SOURCES IS BELIEVED TO BE RELIABLE BUT ITS ACCURACY OR COMPLETENESS CANNOT BE GUARANTEED. THE MENTION OF ANY SPECIFIC SHARES OR BONDS SHOULD NOT BE TAKEN AS A RECOMMENDATION TO DEAL. Issued by Threadneedle Asset Management Limited ("TAML"). Registered in England and Wales, No. 573204. Registered Office: 60 St Mary Axe, London EC3A 8JQ. Authorised and regulated in the UK by the Financial Conduct Authority. TAML has a cross-border licence from the Korean Financial Services Commission for Discretionary Investment Management Business. Issued in Australia by Threadneedle International Limited ("TINTL") (ABN 133 962 055). To the extent that this document contains financial product advice, that advice is provided by TINTL. TINTL is exempt from the requirement to hold an Australian financial services licence under the Corporations Act in respect of the financial services it provides. TINTL is regulated by the Financial Conduct Authority under UK laws, which differ from Australian laws. Issued in Hong Kong by Threadneedle Portfolio Services Hong Kong Limited 天利投資管理香港有限公司 ("TPSHKL"). Registered Office: Unit 3004, Two Exchange Square, 8 Connaught Place Hong Kong. Registered in Hong Kong under the Companies Ordinance (Chapter 32), No. 1173058. Authorised and regulated in Hong Kong by the Securities and Futures Commission. Authorisation does not imply official approval or recommendation. The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document you should obtain independent professional advice. This document is distributed by Threadneedle Portfolio Services Hong Kong Limited Dubai branch, which is regulated by the Dubai Financial Services Authority ("DFSA"). The information in this document is not intended as financial advice and is only intended for persons with appropriate investment knowledge and who meet the regulatory criteria to be classified as a Professional Client under the DFSA Rules. Issued in Singapore by Threadneedle Investments Singapore (Pte.) Limited, 3 Killiney Road, #07-07 Winsland House 1, Singapore 239519. License Number: CMS100182-1. This document is being issued in Singapore to and is directed only at persons who are either institutional investors or accredited investors (as defined in the Securities and Futures Act, Chapter 289 of Singapore) in Singapore. This document must not be relied or acted upon by any persons in Singapore other than an institutional or accredited investor. Issued in the US by Threadneedle Investments International Limited ("TINTL"), a UK-based investment management firm that provides financial services to individual and institutional investors. TINTL is registered as an investment adviser with the U.S. Securities and Exchange Commission and is authorised and regulated in the conduct of its investment business in the UK by the UK Financial Conduct Authority. Threadneedle Investments is a brand name and both the Threadneedle Investments name and logo are trademarks or registered trademarks of the Threadneedle group of companies.

www.threadneedle.com