Time to broaden horizons in Europe

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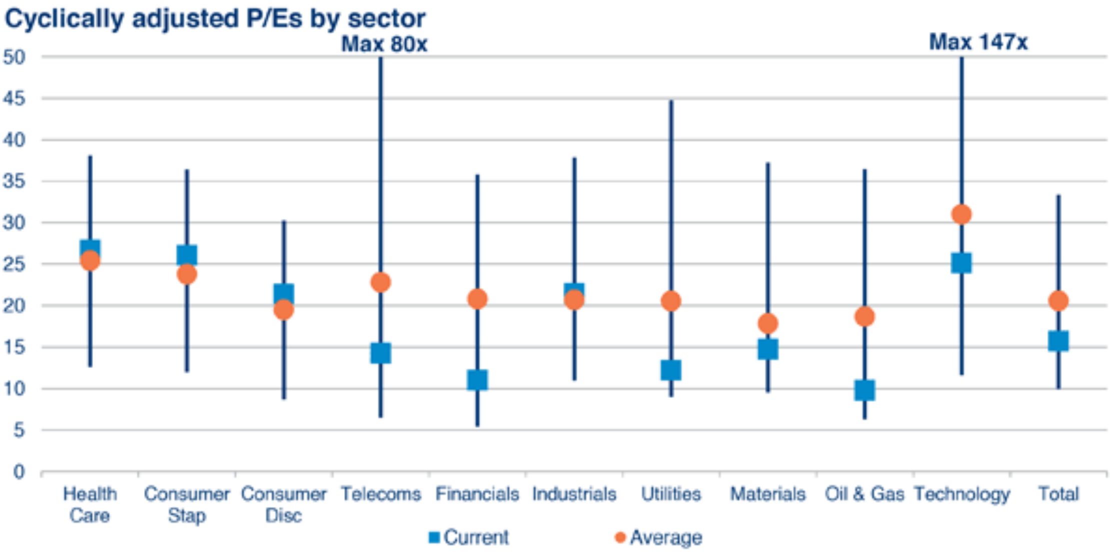
After strong performance from value shares, Martin Skanberg explains why now may be the time to return to higher quality and more defensive areas of the market.

The last two years in European equities have been dominated by recovery and value trades. These areas of the market suffered a sharp sell-off during the eurozone crisis as the survival of the single currency area hung in the balance. The turning point came in July 2012 when European Central Bank (ECB) President Mario Draghi pledged to do 'whatever it takes' to preserve the euro. That restored confidence and investors consequently sought out those shares that were a play on the eurozone recovery, resulting in value areas of the market outperforming growth by around 40-45% over the past two years. Following these strong gains, it may now be time for value and recovery to hand over the baton of market leadership.

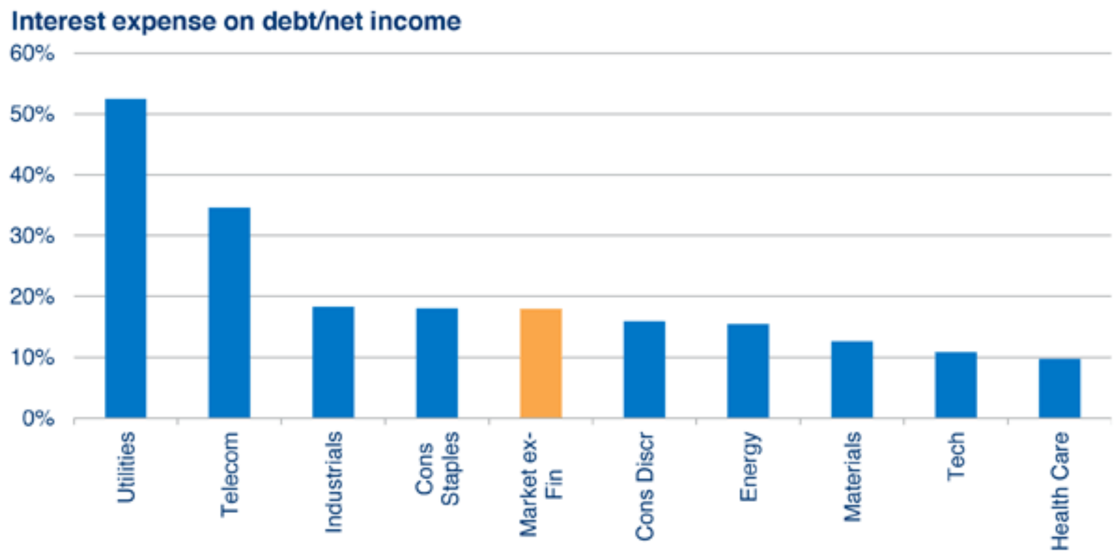
The recent actions taken by the ECB to ease monetary policy should be pro-growth and supportive for equities. Part of the ECB's aim is to weaken the euro, which would help the eurozone's exporters and stave off the spectre of deflation via more costly imports. The paradox though is that the perceived success of the ECB's policies over the past two years has driven inflows of capital into the eurozone, which has pushed the euro higher. It remains to be seen what the longer-term trend will be. Further measures – such as outright and unsterilized asset purchases – may be needed to cap further significant euro appreciation until the US Federal Reserve's tapering action graduates into the first of a series of interest rate hikes.

While there is no longer the prospect of a eurozone break-up, growth rates in the single currency zone remain tepid. Were growth to slow, we think that would be the time to start looking at more defensive areas of the market. Utilities in particular offer an interesting opportunity. The sector is still trading well short of its average cyclically adjusted price-to-earnings ratio.



Source: Datastream. Based on data from 31 December 1982 to 30 May 2014.

Utilities also currently have an opportunity to refinance their debt at cheaper rates with sovereign bond yields falling to historically low levels across the eurozone. Bond yields have fallen even further since early June when the ECB announced its unconventional measures. The telecoms and industrials sectors should similarly be beneficiaries of this as companies in these sectors also use a large proportion of net income to service debts. Financials will enjoy a positive impact from reduced deposit and wholesale funding costs. These sectors, especially in peripheral Europe, continue to be of interest to us.



Source: Barclays, Stoxx, Datastream. As at 31 December 2013. The interest expense represents the service charge on the total debt for the company. The market number represents the median value for the Stoxx 600 ex-financials universe.

Indebted peripheral Europe should be an important beneficiary of the ECB's looser monetary policy. Regarding Italy, we would note that Matteo Renzi's government has clear credibility and this is reflected in the current low government bond yields. We think there is the potential to stop the erosion of the credit cycle, and to see both supply and demand for credit improving. After the disappointment of the first quarter GDP figures, we take the view that Italy should start to grow again, albeit probably at a modest pace.

However, it is not the case that opportunities are to be found only in the periphery or in a narrow segment of the market. We would argue that potential equity strength is much wider, including core Europe. Should the ECB introduce outright asset-backed securities purchases and other securitized products, then this could also benefit the more mature parts of Europe. For instance, as corporate spreads tighten in the hunt for yield, the commercial and residential real estate sector in central and northern Europe could revalue significantly. The prospect of generating an asset bubble in Germany may be the ultimate cost of mitigating deflation originating in the periphery and from euro strength.

We also see an opportunity to return to quality stocks such as food & beverages. This is a part of the market that has lagged behind recently amid the rush to buy more cheaply-valued companies. At the same time, the weakness in global emerging markets hit food & beverages companies as their growth rates in these markets began to slow. We would further note that lower bond yields underpin asset prices and asset prices in turn underpin consumer confidence. This rising consumer confidence is something that we want to focus on in terms of the opportunity offered by the consumer-oriented companies within Europe.

Lastly, we would highlight the ongoing rise in merger & acquisition activity, as companies take advantage of low rates to fund takeovers. The largest deal flows initially have been in more defensive sectors, such as consumer staples and healthcare, as well as in some of the quality-oriented industrials. Again, the recovery paradox would seem to indicate decent support for these parts of the market. Looking more broadly, Europe's re-rating looks set to continue as interest rates head towards zero and European equities remain attractively valued compared to their own history and to other markets. We are also starting to see early signs of positive earnings revisions. We therefore continue to argue the advantages of a moderately pro-cyclical but well-diversified sector and country allocation.

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