Heartwood
Investment Management

15 April 2016

Investment Insight

Weekly Insight

Europe: A summer of discontent?

Overweighting European equities has been a consensus trade over the last year. Despite robust performance in 2015, the MSCI Europe ex-UK Index has now lost 13% from its April 2015 peak in local currency – a large proportion of those losses due to weakness in January. Europe has underperformed both the US and the UK by 7-8% this year, with global risk aversion the dominant factor. Surprisingly, the European Central Bank's (ECB) additional policy stimulus in March did not lead to a durable rally. Furthermore, the ECB's efforts to reflate the eurozone economy through currency weakness have been frustrated by a near 4% appreciation of the euro against the US dollar this year.

Improving sentiment on news of Italian rescue plan

There has been a welcome improvement in sentiment over the last week with the MSCI Europe ex-UK rising 3%. In particular, stock markets have been lifted on news that in Italy a €5 billion bad loans fund, the Atlante fund, will be established to buy pools of non-performing loans from lenders. The Fund, financed by the larger banks, insurers and institutional investors, is modest in the wider context of Italy's €360 billion non-performing loan overhang, but nonetheless many investors view this as a first positive step towards instilling some stability into the Italian banking system.

Longer-term cyclical recovery remains intact

We believe that the longer-term cyclical recovery story in Europe remains intact and thus remain overweight from an equity perspective. Credit channels are recovering and domestic demand remains firm as labour market improvements continue. The ECB's stimulus measures will take time to feed through into the real economy, but we expect these measures to add further support to the expansion of credit across the region.

…but prepare for escalation of risk in the near term

However, we also believe that the positive momentum seen in recent days could prove temporary. Given the bounce in markets, we now consider it to be prudent to reduce some of our overweight risk as we approach a potentially volatile summer.

In particular, it is noteworthy that both equity and fixed income markets have generally overlooked individual country events in Europe this year, including unresolved elections, ongoing financing issues in Greece and the escalating migrant crisis. These issues have not necessarily been concerning for markets in isolation, but the risk of a collision in the summer could create challenges for European assets. In particular:

• **Rudderless politics:** Spain is four months on from the election and the country is no closer to forming a government. The most likely outcome will be a fresh set of elections in June. Ireland has also yet to establish a working government, since no party secured an overall majority in February's election. Both Spain and Ireland have been the stronger economies in the eurozone region, but their political establishments are under pressure following years of austerity.

• **Unresolved financing issues in Greece:** Relations between the Greek government and the International Monetary Fund have deteriorated over recent weeks and this may have implications for the disbursement of funds in July. The key areas of disagreement include pension reform and fiscal spending. June and July will be a critical period when the Greek government needs to make loan payments totalling over €3 billion to the IMF and the European Central Bank.

• **Brexit:** Opinion polls are expecting a win for 'Bremain' but politics is not always predictable. Uncertainty around the upcoming referendum could be accentuated by issues such as the European Union migrant crisis: numbers are rising as the warmer months approach. The Greek sovereign debt crisis could also add to fears around the European project, its costs and cohesion.

June will be an especially busy month with Brexit, Spanish elections and the approaching repayment deadlines for Greece. Investors should enjoy the temperate climate while it lasts…

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Risk Warnings:
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