



European equities: Don't lose faith yet

Performance in European equities has been disappointing this year. As well as underperforming US and UK equities this year, the region has lost more than 5% in local currency terms. Returns in sterling have fared much better at 9%, though this has all been driven by the UK currency's depreciation since the Referendum. Concerns linger about 1) the solvency of the Italian banking system; 2) Brexit negotiations that are likely to ensue for many years and the resultant impact on the drive towards deeper eurozone integration; 3) populist politics as various elections are being held across continental Europe over the next year.

Economic fundamentals are unchanged

Many of these concerns have led investors to shed their European equity positions in recent months, turning towards more defensive markets, such as the US, or travelling further along the risk spectrum and diversifying into emerging market equities. In terms of our own positioning, we have also reduced some of our European equity allocation. However, we continue to hold a modest overweight exposure on the view that the cyclical recovery story remains intact. In fact, there are a number of factors that we consider are supportive to the market's recovery:

- **Eurozone resilience.** Eurozone financial markets have shown more resilience than compared with more turbulent periods in 2011 and 2012. Headline events, such as the Spanish elections, had limited market impact and euro sovereign peripheral debt spreads (i.e. the difference in yield relative to the risk-free rate) have remained relatively stable. Domestic demand continues to be a big driver of growth in the eurozone and it is encouraging that broader economic confidence indicators have held up well post the UK referendum.
- **Domestic demand is being supported by credit cycle improvements.** European Central Bank (ECB) stimulus measures continue to have a positive impact on bank lending, despite concerns earlier in the year that negative interest rates could hurt banks' profitability and lead to retrenchment in lending. The ECB's second quarter bank lending survey showed credit conditions had eased amid improving demand for loans among households and non-financial corporates. It is interesting to note that ECB policy measures are increasingly directed at boosting credit as opposed to weakening the currency.
- **European bank balance sheets are stronger than they were in 2011/12.** The ECB stress tests show that banks in most countries have come a long way in boosting Tier 1 capital ratios and have stronger buffers in place to withstand a significant market or systematic impact. The Italian banks are the obvious outlier, given concerns around the solvency of smaller banks and how to address the issue of private bail-ins, since Italian bank bonds are predominately owned by retail investors who would not be in a position to absorb large capital losses. However, progress is being made at the regional level and the European banking system is much healthier than in 2008, or indeed, in 2011/12 at the height of the euro sovereign crisis.
- **Valuations are cheaper and the reduction of investor positions** in European equities means that it is a less owned market. This provides the basis for stronger demand in the future as the fundamental outlook improves.



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- **Less focus on fiscal austerity.** Governments have been able to maintain a looser fiscal stance this year than compared with previous years. We have also seen the European Central Bank and European Commission show a more pragmatic response towards countries' fiscal policies. The Spanish and Portuguese governments avoided fines in July for not cutting their budget deficits sufficiently, and have been given more time to resolve these financing issues.

Credit cycle is key, but valuations also supportive

Political risk in Europe remains elevated and in the near term investors will have to prepare for the headwinds of the Italian constitutional referendum in Q4 2016 and regional elections in Germany. Beyond the headline noise, however, the eurozone credit cycle is key to European equity markets staging a recovery. As long as we continue to see ongoing balance sheet repair among European banks and improvements to the credit cycle, we believe these fundamental drivers should underpin European equity performance. Furthermore, given that valuations are now cheaper and it is a less owned market, these technical factors give us more comfort in holding an overweight position.

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