Heartwood
Investment Management

03 February 2017

Investment Insight

Weekly Insight

European equities: Focusing on fundamentals over politics

European equities has been an unloved market over the past year, with performance lagging the US, UK and emerging markets. While it remains an out-of-consensus trade, recent developments have reinforced our view to maintain an overweight equity position to this region for the following reasons:

- **A stabilising economic backdrop.** Survey and sentiment data have seen encouraging improvements. The eurozone PMI manufacturing survey is at its highest level since 2011. New orders in particular came in at a five-year high, suggesting that, all else equal, confidence in the coming months remains robust. The gains are broad-based across countries with France seeing a meaningful improvement. Consumer confidence also remains at a multi-year high, despite headline political risk, while wage growth has been improving in some economies, such as Germany and Spain.

- **Credit growth remains supportive.** Low interest rates and abundant European Central Bank (ECB) liquidity are keeping financial conditions loose. Demand for loans has improved in every country since the start of the ECB's quantitative easing programme in January 2015, with Germany and Spain accounting for the strongest increases. Concerns have eased around the impact of negative interest rates on banks' profitability and their ability to lend, as longer-term interest rates have increased and bank share prices have recovered.

- **Rising inflation expectations are generally good for European equities.** History shows that this market tends to perform better when growth and inflation expectations rise globally. There are two reasons for this phenomenon. First, European companies derive 50% of their sales outside of Europe. Second, and more crucially, these companies tend to have a higher fixed cost base and are therefore are more sensitive to changes in sales, meaning that they should benefit more on the upside as sales pick-up. European equities suffered from meaningful outflows in 2016 – almost as big as those seen in 2008 – but the pace has moderated since mid-October, coinciding with a pick-up in earnings upgrades.

- **Corporate earnings growth is improving.** Earnings-per-share growth turned positive in most regions in the third quarter of 2016, following four consecutive quarters of contraction. Financials and commodities are now expected to contribute positively to the aggregate earnings picture, with a weaker euro also helping exporters.

Inevitably, though, the political calendar in 2017 complicates this investment thesis, as event risk is likely to be at the forefront of global investors concerns. While political headline noise will contribute to short-term swings in investor sentiment, the main support for European equities is that we are now seeing real, fundamental economic improvements across the region, accompanied by prospects of stronger company pricing power and profitability. These improvements should help to ameliorate some of the populist forces in key countries facing elections this year – the Netherlands, France, Germany and, possibly, Italy. The key risk is France. But even here, our base case is that the centrist forces will coalesce to stop a Le Pen presidency. If so, there could be a realistic prospect that France could elect a 'change' candidate in favour of reforming the economy.

Investing in European equities is not necessarily for the faint-hearted, but we believe there is scope for this market to outperform this year.

Jaisal Pastakia
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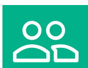
Clear Thinking



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