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## European equities – a strong start to 2011

Europe the best performer YTD 2011

Many investors have written off European equities due to political uncertainties and euro scepticism, yet since the start of 2011 the region has been the best performer among the major developed markets (see Table 1).

Exposure to global growth at lower valuations

European equities offer exposure to global growth, not just domestic, and at lower valuations than other regions. Over a third of sales are to regions outside greater Europe. The main indices in the region are populated by global multi-national companies whose fate last year was partly determined by their country of domicile.

Table 1: Global index valuation and performance

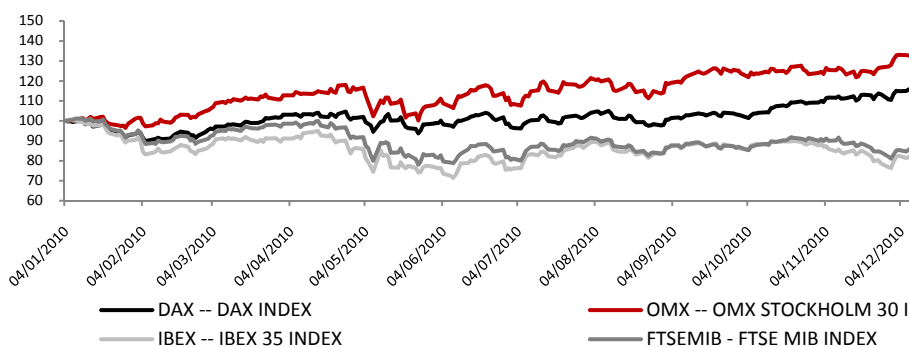
Index	Trailing P/E	Dividend yield	YTD performance	12m performance
DJ EuroStoxx 50	12.9	3.7%	+6.1%	+9.2%
FTSE 100	16.8	3.2%	+2.7%	+17.8%
S&P 500	15.8	1.8%	+2.9%	+21.0%
Nikkei 225	19.4	1.6%	-0.6%	+13.7%
Hang Seng	14.3	2.8%	-2.6%	+11.3%

Source: Bloomberg, as at 14/02/11, returns in GBP

North v south trade now overstretched

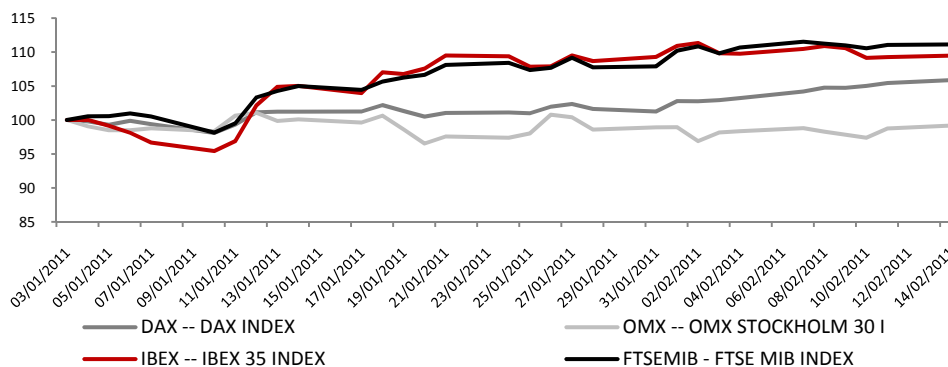
The argument last year was one of north versus south, with markets such as Italy the underweights. It was also a case of cyclicals versus financials, with the north having higher exposure to the former and the south to the latter. These trades have become overly stretched, as evidenced by the reversal in January.

Chart 1: European equity market performance in 2010



Source: Bloomberg as at 14/02/11, performance in EUR

Chart 2: European equity market performance in 2011 YTD



Source: Bloomberg as at 14/02/11, performance in EUR

### Significant exposure to international earnings

Let us look at each of these areas in turn. In southern Europe, an overweight position in Spain was met with raised eyebrows and an air of disbelief last year. However, we held just such a position in the second half of 2010 as within the market Europe; the six largest companies account for over 70% of the index and derive over 50% of their profits internationally. Hand in hand with this investment view was a belief in the sustainability of the European project, clearly not shared by many.

### Political will for continuation of euro

We consider the euro to be a politically-based currency and while there is continued desire for it to exist, the politicians will do whatever is necessary. They may not talk in a co-ordinated fashion but they do want the single currency to continue and Spain was always going to be the battleground and would be supported as long as major concessions were made on pensions, labour and banking reform. These are now happening in Spain; the retirement age has risen to 67, the costs of laying off workers has more than halved, reforms on collective bargaining are expected shortly, the 'caja' regional banks are being restructured and the equity market is responding positively.

### Northern European advantage set to wane

Meanwhile in northern Europe Germany and Sweden could do no wrong in 2010. They were huge beneficiaries of the emerging market growth trade and became overweight positions in most portfolios as a result. However, we would argue that going forwards they will not continue to enjoy the advantage of better newsflow relative to their southern counterparts. Although the economies remain strong, the impact of a slowdown in emerging market growth (on both Germany and Sweden) and a strengthening currency (in the case of Sweden) means that it is difficult to see where the marginal buyers will come from, compared with Spain and Italy, where political rhetoric is arguably improving and portfolios have typically been very underweight.

### Remain overweight Italy and Spain, and cyclical and financials

From a country perspective we are overweight both Spain and Italy, compared with a more neutral stance on Sweden and Germany. On a sector basis we believe that we have just entered the second year of a new business/economic cycle, which would typically last for four to five years. This means that companies exposed to economic growth, such as cyclicals and financials, where we are overweight, should see excess profit growth relative to companies in more defensive sectors, where we are underweight. With banks among the least favoured stocks in fund manager ownership surveys in early 2011, we expect this level of under-ownership to lead to short term outperformance from financials. Overall, we conclude that European equity markets remain significantly undervalued and are likely to benefit over time as weightings are rebuilt following the 2010 exodus.

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