ARE EUROPE'S DOG DAYS OVER?

Boasting a broadly improving macroeconomic environment, the prospects for Europe are on the turn. What's more, the investment case for the region is too good to ignore, explains Ian Ormiston, manager of the Old Mutual Europe (ex UK) Smaller Companies Fund.

The European tide is turning. After years of relative stagnation, the backdrop for European equity investors is now a handsome one.

The European stock market is currently trading at a discount to the likes of the US and, historically at least, such a valuation differential has been perfectly justified. Long dogged by the institutional intricacies and vagaries that come with being entwined with the European project, the unknowns have always outnumbered the certainties. And while today sees European equities still cheaper than their US peers – the European equity market is trading on a forward p/e ratio of 15x versus the US market p/e of 18.3x[1] – this seems to be unfairly swayed by the prevailing political winds that gust across the continent.

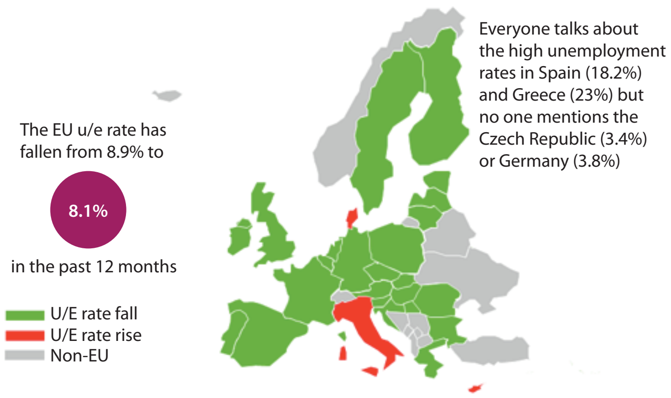
A turnaround story…

Since the European Central Bank (ECB) commenced its sovereign bond-buying programme in 2015, economic growth across the region has rolled along at around 1.6% year on year, creating 1.7m jobs per annum. Across Europe, domestic economic activity is picking up at a healthy pace. No longer is the region in the grip of Japan-style deflation; for too long, profit margins had been unable to expand and pricing power was largely absent. Now, though, we are seeing rising prices, rising levels of employment and disposable incomes pacing ahead on the back of improved productivity growth.

The virtuous circle of economic expansion, so long estranged from the region, looks to be back once again.

MAKING IT WORK: A EUROPEAN EMPLOYMENT TAILWIND

YEAR-ON-YEAR EU UNEMPLOYMENT RATE CHANGES TO JANUARY 2017



Source: Eurostat as at 31/01/2017, seasonally-adjusted unemployment rates.
Past performance is not a guide to future performance. The value of investments can go down as well as up and is not guaranteed.

With the exceptions of Finland and Greece, economic growth throughout Europe is broad and embedded. Meanwhile, the age of austerity is over. While the region's central bankers are by no means in full expansionary mode just yet, the benefits – both psychologically and practically – of the removal of the austerity yoke from around the necks of European economies, the heavy burden of repeated year-on-year budget cuts, are hugely significant.

The euro's relative weakness is also proving a handy tailwind; as a global exporter of pharmaceuticals, cars and high-end machines, a bit of currency softness is by no means a bad thing. And then there's employment growth, a phenomenon in evidence right across the region (see infographic). The huge stock of unemployed people, of all ages, is gradually being whittled down. Of course, the likes of Greece and Spain are still dogged by uncomfortably high jobless rates – 23% in Greece and 18.2% in Spain[2] – but these have been edging down consistently over the past 12 to 24 months. There's still a long way to go but we are heading firmly in the right direction. An economy often tagged with the 'slow and steady' label looks to be living up to expectations, and slow and steady should mean a long-awaited period of self-sustained economic strength.

… but challenges remain

Now, it goes without saying that any such statement of optimism comes with its fair share of caveats. Europe's economic prospects remain firmly under the influence of the goings-on at the top table of the European Union (EU). Any fracture of the institutions of the EU would have serious ramifications. What could cause such a fracture? The forthcoming French election is one such potential road block but we would expect any possible 'Frexit' – in the event of a Marine Le Pen victory – to be met by a closing of the EU ranks and a seismic show of unity. Ultimately, the scale of the political and economic investment that has been made in the EU means that its failure is unthinkable to those invested. A continental equivalent of 'Brexit' would only make the EU more determined to succeed.

There's also the ever-evolving relationship with Russia to factor in. An escalation of rhetoric or sanctions with Russia could have a dampening effect on Europe's economic fortunes. Indeed, the softening of sanctions on Russia in recent times has had an economically beneficial impact on Continental Europe and, in particular, Germany. The relative normalisation of the relationship with Russia is something to be savoured from an economic point of view, but can it last?

A further uncontrollable challenge could come in the form of a US dollar devaluation, an event that would have a notable weakening effect on Europe's important export sector. Closer to home, there is also the possibility that the ECB responds to the first signs of inflation by tightening monetary policy and, in so doing, nipping the region's economic renaissance in the bud. A possibility, yes, but there is little suggestion that the ECB would currently consider such a course of action.

A broad opportunity set

All of these potential roadblocks are exactly that – potential. In the here and now, it is an inescapable fact that the European economic backdrop is as good as it's been in many a year. And with this good news still yet to be fully priced in by markets, we believe this is a real opportunity for investors.

What's more, and this is something we say regardless of the prevailing economic winds, Europe is a disparate and niche market in which to invest. We invest in companies, not countries and not the continent as a whole. Even in the worst of times, it is an under-fished ocean and a fruitful one for those investors who look hard enough.

FOOTNOTES

[1] Citi, 24/02/17; [2] Eurostat, 01/03/17

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