

# MARKET INSIGHTS

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## European equities: A long-term perspective



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### Stephen Macklow-Smith

writes in his capacity as a senior portfolio manager within the European Behavioural Finance (BF) team, with more than 20 years' experience of managing European Equity funds. His views are intended to give some insight into market events from the BF point of view, but are based on personal opinion. His opinions may therefore diverge from other views within J.P. Morgan Asset Management, and do not necessarily reflect the Global Multi Asset Group (GMAG) team outlook, which is based on a 3-6 month time horizon and reflects the investment strategy of our GMAG Group.

### Introduction

*European equities have outperformed the rest of the world over the long term, thanks to the innovative products produced by the region's dynamic corporate sector.*

*In this paper, Stephen Macklow-Smith applies a long-term perspective to European equity investing, looking at the unique factors that have powered the region's outperformance. He also assesses earnings growth and valuations, and discusses the themes currently shaping the markets.*

### The long view

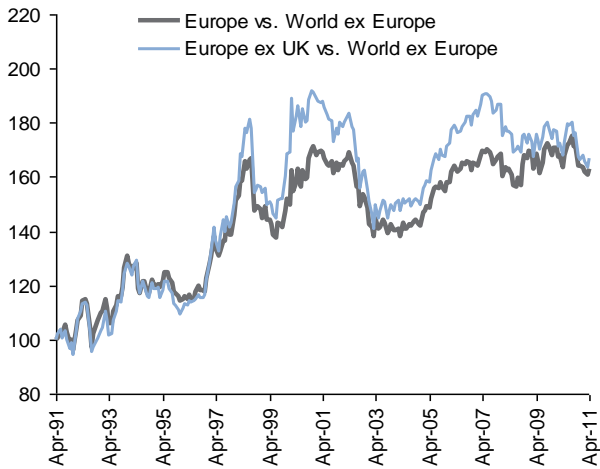
Investors are faced with a wall of noise. 24-hour rolling news and market coverage mean that every market move is noted and scrutinised. But while volatility is a fact of life in today's markets, it isn't the story.

Over the long term, the real story of markets is one of growth in productivity, which drives economic growth and stock market performance. Understanding which companies are showing the best productivity growth, and the reasons why they're showing it, is key in unlocking value over the long term. At the company level, this means paying attention to margins. At the market level, areas that exhibit durable productivity growth over the long term tend to prosper.

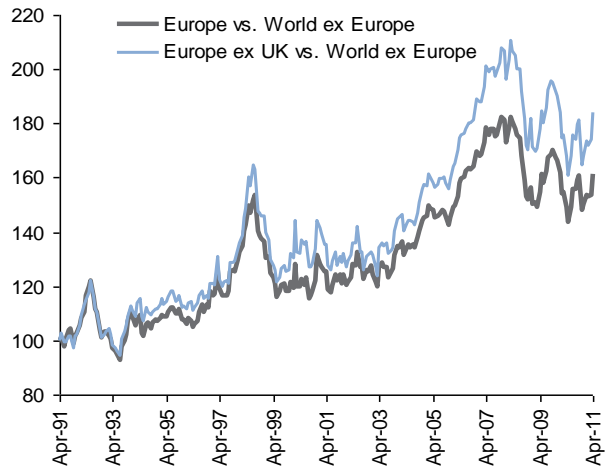
**Exhibit 1** shows the performance of European equities over the past 20 years in comparison to the world excluding Europe. In local currency terms, Europe (including or excluding the UK) has outperformed the rest of the world. However, performance in local currency has been volatile, and trends, particularly in the last ten years, have not been clear. In constant currency terms, though, a significant pattern of outperformance emerges. Including the UK, Europe has outperformed the rest of the world by just over 2% per year. Excluding the UK, it has outperformed by almost 3%.

Exhibit 1 – The long-term performance of European equities

20 year relative performance (in local currency)



20 year relative performance (in USD)



Source: Datastream. Data to 30/04/2011. Rebased to 100 as at 30/04/1991. Series used are Europe = MSCI Europe, Europe ex UK = MSCI Europe ex UK, World ex Europe = MSCI World ex Europe. Indices include reinvested dividends.

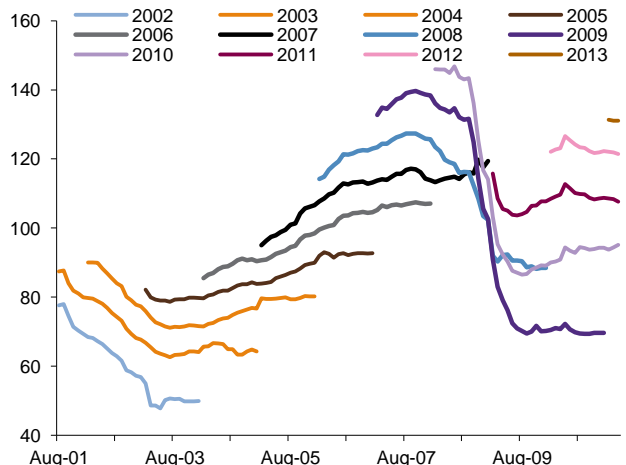
This data illustrates an important point about Europe and the euro. At the heart of the euro project is the desire to be a low inflation, strong currency region. This sets Europe apart from the mainstream economic wisdom that it is necessary to be able to devalue the currency regularly to maintain competitiveness. Devaluation, however, can lead to higher inflation, and to higher interest rates to contain inflation and compensate investors for the risk of holding the currency.

Companies based in a strong currency area can't simply compete on price, because as the currency strengthens they become uncompetitive. Instead, they are under pressure to reinvest continually in their business to drive themselves up the value chain and enable themselves to compete on quality. This is as important now as at any time in the last 20 years. In every sphere, Europe makes products that people around the world aspire to buy. The growth in European profits in the past two years has been driven by precisely this appetite for buying best in class.

Earnings expectations remain robust

The strength of Europe's companies is being reflected in corporate earnings. **Exhibit 2** charts the movement of earnings expectations over the past ten years. Each line represents consensus expectations for one year's profits, illustrating the changing expectations as more information emerges about how business is progressing over the year.

Exhibit 2 – Earnings estimates



Source: MSCI, IBES, Factset, Morgan Stanley Research. Note: Data calculated before goodwill and in local currency terms. Data as at 9 May 2011.



In 2008 and 2009, the effect of the credit crisis is evident in steep fall-offs in profitability. Since that period, however, the recovery has driven steady growth in profit expectations, largely due to improving margins. The chart also shows that consensus expectations are for further growth in 2012 and 2013.

The evidence of the current earnings season adds to our confidence that these expectations are reasonable. Consumption is being challenged by higher commodity prices, which are also pushing up input costs, and in the fourth quarter of 2010 this was reflected in disappointing guidance from some companies. However, this effect has receded in the first-quarter reporting season, and company results are again exceeding expectations.

### Long-term valuations continue to offer support

Thanks to robust earnings growth, European equity valuations remain reasonable despite the rise in prices since March 2009.

In **Exhibit 3**, the left-hand chart shows the Shiller price-to-earnings (P/E) ratio, an adjusted P/E designed to strip out short-term noise. The Shiller P/E compares current prices to average earnings over the past ten years, removing the effect of the market cycle. By this measure, valuations are not demanding relative to history. The right-hand chart shows a Morgan Stanley composite valuation indicator. By this comparatively short-term measure, valuations appear slightly demanding relative to recent history, although not yet into tactical selling territory.

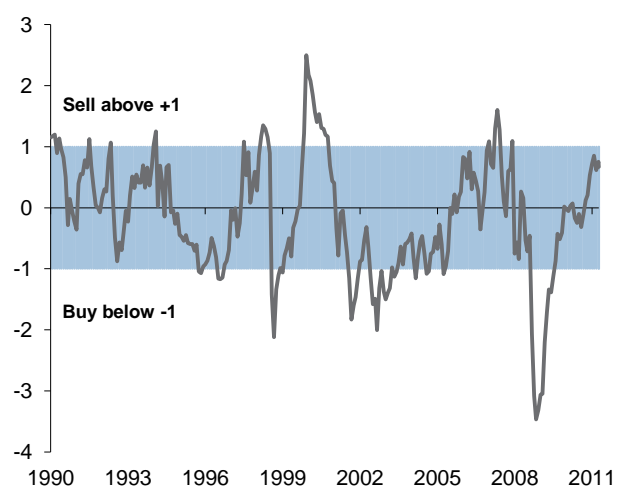
In the short term, we may therefore be nearer the top of the valuation range, but long-term valuations remain supportive. Therefore, provided earnings growth remains intact we believe it would still be worth buying on any dips in price.

Exhibit 3 – European Equity valuations

Shiller Price to Earnings



Composite Valuation Indicator



Source: Morgan Stanley. Note: Shiller PE defined as inflation adjusted price to 10 year average EPS. Data as at 9 May 2011.

Current market themes

**1) Peripheral Europe**

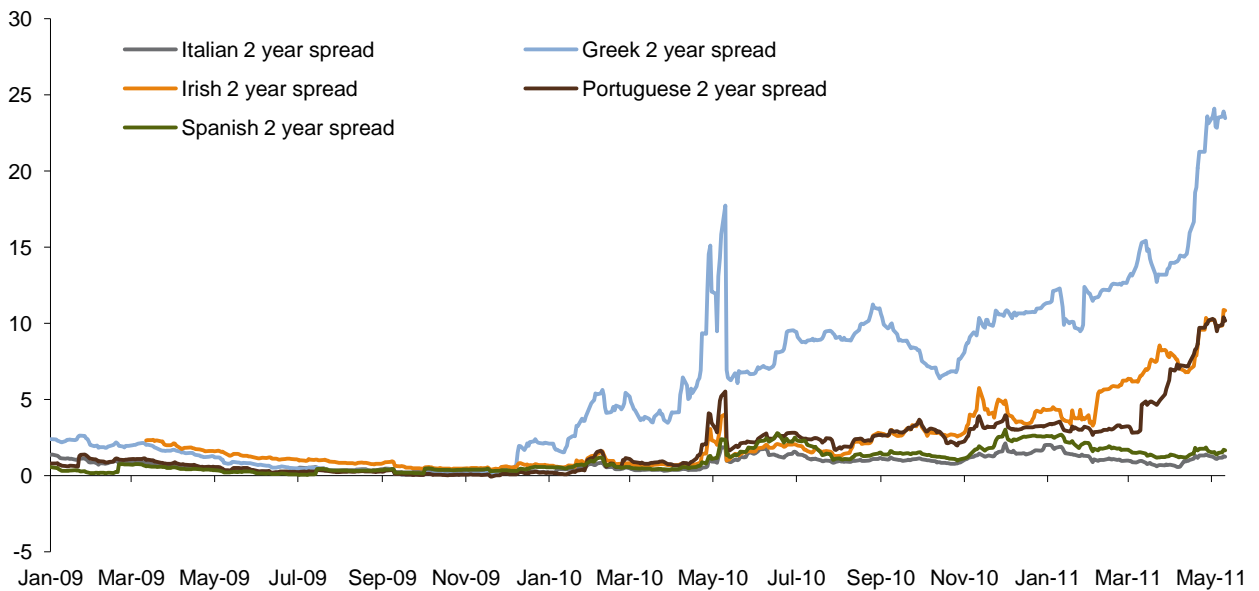
In the near term, the peripheral eurozone debt crisis remains a key theme in European equity investing. Until the picture becomes clearer, it's impossible to know what the outcome will be; what is clear, though, is that there is a strong desire in the European Union to guarantee the integrity of the euro.

In the meantime, it's important to note that the problems in peripheral countries are not equal. The market has already begun to distinguish between Greece, Portugal and Ireland, which have asked for help, and Spain and Italy, which have not. Although there is a lot of talk about problems in Spain, Spanish debt spreads have decoupled from those of Greece, Portugal and Ireland, and are trading nearer to those of Italy.

As the authorities seek to come up with a solution to the problems in the periphery, stockpicking is therefore more important than ever. Rather than applying a simple rule of thumb to the eurozone periphery, it's important to take into account the differences between individual economies, and between individual companies.

Exhibit 4 – Peripheral European debt spreads

Bond spreads vs. German Bunds



Source: Datastream. Data to 11 May 2011.

2) Cash on corporate balance sheets

Since the financial crisis, companies have built up the cash on their balance sheets, using their improving margins to accumulate a substantial cash cushion. This is a rational response to the sudden freeze in credit availability in 2008 and 2009. However, with faith in the strength of the economy beginning to be restored, companies are starting to look at how their cash is being employed.

With interest rates still extremely low by historical standards, the return on cash on the balance sheet is much lower than it would be on cash put to work in the business. We therefore expect a rise in capital expenditure, which will help to underpin economic growth in the next two years. We have also already begun to see

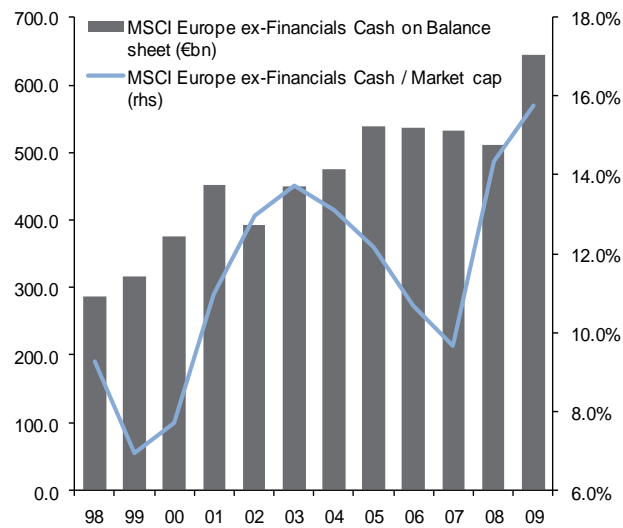
a pickup in merger and acquisition activity, but as **Exhibit 5** shows this remains low by historic standards. We anticipate that volumes will rise further as companies continue to take advantage of opportunities where it is cheaper to buy assets than build them.

In the past, M&A activity has been seen as dilutive to shareholders. However, a recent study from Cass Business School shows that companies that made acquisitions in the first quarter of 2011 actually added shareholder value<sup>1</sup>. This makes sense in the current environment: the return on cash is so poor that redeploying it into productive assets is likely to improve returns to shareholders. In the coming year, equity valuations should therefore receive support from further growth in M&A volume as companies take advantage of these favourable conditions.

<sup>1</sup> Source: FT.com, 1 May 2011. Research by Towers Watson and Cass Business School found that European companies that completed deals worth at least USD 100m saw average share price returns of 12.2 percentage points above the wider market in the first quarter of 2011.

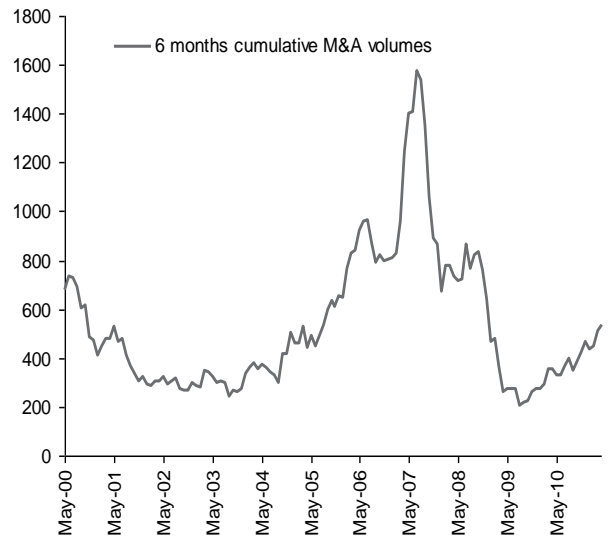
Exhibit 5 – Cash-rich corporates driving increase in M&A activity

Cash on MSCI Europe balance sheet



Source: J.P. Morgan Cazenove, IBES. Data as at 31/12/10.

Volume of European M&A



Source: Datastream. Data to 30/04/11.

### Conclusion

European equity markets remain volatile as the repercussions of the sovereign debt crisis continue to play out. But beyond this short-term noise lies a story of steady outperformance, driven by improving productivity and by demand for Europe's high-quality exports. With robust earnings growth and reasonable valuations lending support, the long-term outlook for the region appears bright. In the near term, rising M&A activity should also provide a boost, while even the peripheral markets offer some attractive opportunities for stockpickers.

### Summary

- ✓ European equities have delivered long-term outperformance
- ✓ Earnings are still improving
- ✓ Long-term valuations are not demanding
- ✓ Peripheral debt problems can be contained
- ✓ Increasing M&A is underpinning asset values

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