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The first quarter earnings season in Europe has been stronger than expected. We have upgraded our Eurozone 2011 GDP growth forecasts from 1.5% to 1.9% following strong Q1 growth of 0.8% quarter-on-quarter, admittedly helped by the weather. The euro has come off its 2011 high against the dollar of almost 1.50 to fall to 1.41.

Meanwhile confidence in the periphery economies continues to fall. In Greece, credit spreads continue to widen as the government suggests a budget deficit target of 1% in 2015. In Italy the response to being put on short-term credit watch by S&P was to target a balanced budget in 2014. The Spanish local elections delivered a resounding defeat to the incumbent left wing government.

Hence European headlines remain dire. They continue to concentrate on the unsustainability of debt levels in Greece as well as Ireland and Portugal. Spain and Italy are being sucked into widening spreads, although by no means to similar degrees. Talk of the 'end game' appears premature but there does now seem to be acceptance that Greece will default, reprofile or something in between. The 'if' has progressed to the 'when' (and how). Our belief is that the European authorities will seek to delay this day until the European financial system is in a stronger state, or that an even larger proportion of Greek debt is held by the ECB and other European authorities/institutions.

At the very least Europeans want to avoid contagion or the implosion of the financial system. Hence the desire to delay until European banks are better capitalised. The risk to this is the widening of Spanish and Italian spreads, which could conceivably bring the crisis to a head, since these countries need to be able to refinance themselves at viable rates. At the moment we believe such a move is unjustified but the further spreads widen, the more the move becomes self-fulfilling.

On a more positive note, valuations look compelling. At less than 10x next year's earnings either our numbers are wrong, earnings are set to fall thereafter or the market is particularly cheap. There is an argument which suggests that the macro will lead Europe into lower economic activity and earnings than we estimate, but our central forecast is that we muddle through and in fact that growth is stronger this year than we had previously forecast. Companies in 'core' Europe in particular are benefiting.

Yielding almost 4% this year and at a PE of less than 10x next year's earnings, I believe European equities look attractive. Balance sheets outside the financial sector remain strong, companies that don't need the money can borrow very cheaply, and I believe that these companies will use the low cost of debt to invest in themselves and other companies and drive returns higher.

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