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EUROPEAN EQUITIES – ASSESSING VALUE AS FORECASTS FALL
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Continental European equity markets have fallen some 20% in the past month, leaving them around the average level of the past fifteen years. The reasons for the decline have been well documented, including global economic slowdown and persistent crisis within the euro region. Where does this leave the market in terms of value?

We are reducing our economic forecasts, from 1.9% GDP growth in the eurozone this year to 1.7% and from 1.5% to around 1.0% in 2012. The main reasons for this are threefold. First, US and global economic growth forecasts are being downgraded and this will impact Europe. Second, euro-area Q2 GDP growth was weaker than expected, although some of this can be put down to global supply chain dislocation after Fukushima and an extra strong comparator in Q1. Finally, the continued wrangling within the eurozone dents confidence given the destabilising widening of riskier credit spreads and uncertainty over the timing or detail of the end game.

If this last element, the euro-area crisis, were to lead to uncontrolled default and/or the break-up of the euro, the hit to eurozone growth would undoubtedly be more significant. This is not our central case. However, the uncertainty over the timing and degree of the destabilisation of this whole saga leads to differing economic views. Hence our conviction in our growth forecasts is not as strong as at other times.

Impact on earnings

Two months ago we reduced our Europe ex-UK earnings estimates to 8% growth in both 2011 and 2012. Given our lower economic forecasts it would be consistent to reduce our earnings estimates too. Half way through 2011, any change is unlikely to impact this year too dramatically unless we start to see write-offs, for instance in the financial sector. For 2012, on the other hand, a global slowdown would have a more profound effect on earnings.

We outline the valuation of the market below given three scenarios: our original earnings growth projection of 8% for this year and next; a second showing 5% this year and flat next, and a third with 5% in 2011 and a 15% fall in 2012. The 2012 PE valuation of the market ranges from 8.5x at the original, most optimistic end of the scale to 11.1x given a 15% fall next year. None appears expensive. However, given protracted deleveraging and current elevated margins, it could be argued that 2012 need not be the trough.

Europe ex-UK net profits from ordinary operations

	2007	2008	2009	2010	2011e	2012e
EPS growth	+6%	-25%	-15%	+35%	+8%	+8%
PER	8.6x	11.3x	13.4x	9.9x	9.2x	8.5x
EPS growth					+5%	0%
PER					9.4x	9.4x
EPS growth					+5%	-15%
PER					9.4x	11.1x

Looking beyond price to earnings

Rather than look at earnings-based valuations it can be useful to look at more stable measures at times of elevated uncertainty over earnings. Hence price to book. Europe ex-UK's price-to-book ratio is currently as low as it has been since 1985, barring Q1 2009 at the height of the financial crisis. Some say that this measure is misleading since banks, insufficiently capitalised, downwardly skew the valuation. Excluding financials, the valuation is indeed less compelling, but still shows the market to be the cheapest since 1994 (again excluding Q1 09).

As well as looking at valuations it is sensible to look at returns. Given that price to book appears to be discounting a scenario as bad as any over the past 17-26 years, what could we expect to happen to returns? Return on equity is currently around 12%, or 14% excluding financials. A price to book around 1.1x or 1.4x excluding financials makes the market look attractively priced, but what could happen to returns? If equity does not move significantly, what can happen to profits? In the last two downturns, EBIT margins have fallen from 15% to 9% in 2007-09 and from 12.5% to 6% in 2001-03. Such a decline in earnings this time would imply profits falling 40 or 50% or so.

However, these were both very severe earnings hits, around double the typical hit of the previous twenty years. Such an outcome is certainly not in forecasts, although the price to book for the market would imply that valuations are priced for an outcome as bad as any over this period.

Another factor over the past thirty years is the discount rate. Long bond yields were far higher in the 1980s when valuations were closer to these levels. The question which arises is this: going forward, do we expect growth rates to be meaningfully lower in order to justify lower equity valuations? Certainly as deleveraging takes place the trend rate of growth should be lower, so it is correct that valuations should be lower. The extent to which this is so will depend on the interaction between lower growth and the lower discount rate at which future cash flows are discounted. Similarly, with lower growth and higher deficits, the dangers of default and instability increase – another reason for the equity risk premium to be higher.

Issues facing the market

There are a number of issues here. Growth rates are likely to be lower in the deleveraging age than before. Lower growth rates mean we flirt with recession more frequently. High deficits in a 'fixed' currency regime require collective help to solve problems for the weak. The political will may be there to provide a solution, but currently there are too many self interests to produce agreement. Hence the situation needs to deteriorate further before crisis brings about the end game – presumably a more common and integrated fiscal and economic policy alongside common guarantees for shared bonds.

Conclusion

The eurozone in aggregate doesn't have an especially bad deficit problem but a number of its constituent members do. Whilst we believe that the hyperbole surrounding the German slowdown is overdone, we do still believe that the euro area is slowing and that earnings will have to be cut. However, the current valuation of the market appears to discount a sharp decline in earnings in the region of 30% plus. I do not believe this will occur unless there is a full-blown crisis, presumably created by the collapse of the euro or a meaningful global recession. Investors are increasingly of the view that one or both of these will occur. I am less convinced and remain a buyer of Europe ex-UK equities, whilst recognising that any path to higher values is likely to be far from smooth.

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