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European View
2 September 2011

The big factor affecting European markets in August has been the downturn in leading economic indicators and the resulting downgrades to GDP and earnings growth forecasts. Set against the background of continued dithering from the authorities as they seek to manage the peripheral debt situation, and magnified by thin summer volumes, the more pessimistic view on growth has resulted in markets moving sharply lower.

However, the past week has seen greater stability and this can be attributed to two main factors. First, the dire outlook suggested by the global leading indicators has not quite fed though to actual economic data – for example the most recent US consumer spending report came in better than expected. And second, market participants have had time to recalibrate their earnings models and found that equities still look good value.

We were already fairly cautious on the economic outlook but we have cut our forecasts further and we have also reduced our earnings estimates. We are now expecting the eurozone to generate GDP growth of 1.8% this year and 1.1% next, with a big disconnect between the (relatively) robust core and a very weak periphery. We have also been fairly aggressive in reducing our earnings assumptions and are now expecting 5% this year and zero in 2012.

On these numbers the market is trading at a price-to-earnings ratio of 9.4x this year's and next year's earnings. This is still well below the long-term average, suggesting that the market has fully discounted the weaker growth outlook as well as incorporating a further risk premium in view of the heightened default risk in the periphery. So far so good, but the uncertainty around the earnings outlook means that it is also prudent to consider other measures of value, such as price-to-book.

This 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 insufficiently capitalised banks skew the valuation downwards. Excluding financials, the valuation is indeed less compelling, but still shows the market to be the cheapest since 1994 (again excluding Q1 2009). Here, too, the market appears to be factoring in a risk premium for a disorderly default in Greece, Portugal or elsewhere.

How big is this risk? Well, the euro leaders' masterstroke of announcing sketchy details of a support package for Greece and then going on holiday for several weeks certainly maximised uncertainty during August, but this seems likely to be addressed in the coming weeks as everyone returns to their desks. The question then is whether the disparate interests of Europe's key nations can be put aside in order to solve a problem that could hurt them all.

The eventual end-game could include quantitative easing and the issuance of eurozone bonds. Such measures would be taken positively by markets. However, we would not bet on the authorities' ability to pull this off without a catalyst - and the catalyst is likely to come in the form of another crisis of confidence.

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So, pulling all this together: the market is attractively valued, even in the light of recent earnings downgrades. This valuation incorporates a risk premium for a likely further crisis of confidence, which will hopefully spur decisive action to solve the sovereign debt crisis. Thereafter, risk appetite should be structurally higher, even if earnings have peaked. This suggests that the market can make progress over the medium term, but that such progress is highly unlikely to happen in a straight line.

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