

## European Equities: Stay Flexible And Focus On Stock Selection

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**The sovereign debt crisis continues to dominate sentiment in Europe (not to mention the world), and investors have had plenty of news to digest over the past week. Indeed, staying on top of the press releases from credit rating agency Moody's alone has been quite a task, with the company downgrading Italian government debt and a whole host of European banks during the week.**

Subsequently, the ECB unveiled a new liquidity programme to support the European banking system in which it offered to buy covered bonds from the banks, in a re-run of the policy it put in place at the height of the credit crunch. To some, these moves show that we are in the depths of a new financial crisis that threatens to bring down the entire financial system; to others, they are a sign that the authorities are alive to the threats and determined to avoid full-blown catastrophe.

One thing is becoming increasingly clear: Greece will default (or "restructure", as it will probably be called) and the holders of Greek bonds will face a significant haircut on their investments. Greece is a small economy but a large bond issuer, and its debt is held widely across the European banking sector. Some banks have been more stringent than others in marking their holdings down. Fears that weaker banks will be unable to absorb the losses have caused liquidity to ebb away, leading to both the Moody's downgrades and the ECB's liquidity programme.

The political decision-making process in Europe over the past few months has often smacked of complacency and inertia. However, it is clear that much work is being done behind the scenes and we believe that a solution to the debt crisis will eventually be found. The problem is that there are significant political hurdles to clear before bodies like the European Financial Stability Fund can be used to put a solution in place. We may need to skirt close to the abyss before the necessary agreements can be reached.

In the meantime, although the ECB is not divorced from the political world, it can at least act more quickly. We have a change of leadership at the central bank this month, with Claude Trichet stepping aside and Mario Draghi taking over. We expect Draghi to reverse this year's two interest rate increases in fairly short order and for the ECB to play a central role as the debt crisis continues to unfold.

Moving away from macro concerns, investors will have a chance to refocus on company fundamentals in the coming weeks as the quarterly earnings season gets into full swing. We are not expecting a significant downturn in aggregate earnings this quarter, although the gains of previous quarters are unlikely to be repeated against a slowing economic background.

We are particularly interested to hear what companies say in their forward-looking statements. If they are starting to see orders being withdrawn then capital expenditure plans may be put on hold, which could ultimately lead to a negative feedback loop into lower demand and ever-weaker economic growth. In the absence of such a development, the market looks very good value and any positive surprises on the earnings or macro front could create a much better market tone. Clearly, the range of possible outcomes remains unusually wide. In these conditions we need to stay flexible and continue to focus on our core competence of stock selection.

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