European equities

Plenty of scope for active managers to add value

Jeffrey Taylor
Head of European Equities
Henley

Key takeaways

- We expect healthy domestic fundamentals to enhance the performance of European equities over the long term.
- With wide disparity in stock and sector valuations, we believe active portfolio management can add value.
- As some sectors are substantially overbought, the case for a period of marked sector rotation is strong.

Europe is a rich, highly developed part of the world which is home to a vast range of companies. However, on occasion it still seems to struggle to attract attention from serious investors around the world. There's always a handy excuse: "Why bother when it's only a play on more interesting parts of the world?" or "There's never any earnings growth, is there?" or "Don't the politics make it un-investable?" Wrong.

The drivers behind the eurozone economy are now predominantly domestic. This is a fundamental break from the recent past when growth was dependent on exports to faster-growing parts of the world. Europe's recovery from the crisis years kicked in later than in the US, but is now firmly on track thanks to a steady, expectation-busting pickup in private consumption and (more recently) investment. Banks are lending again and unemployment is falling. A domestic demand-led recovery is far harder to stop in its tracks than one based on exporting your way out of trouble. This means Europe should be better able to cope with exchange rate fluctuations. It also has major ramifications for the kinds of stocks we want to own.

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Earnings growth should continue in 2018

Earnings growth is back. After a very respectable increase in 2017, the stars are looking well-aligned for 2018 given our economic outlook. Early indications also point to further acceleration in capital expenditures in 2018, implying positive knock-on effects for the corporate ecosystem.

And then there's politics

Politics is always good for a headline or sound bite in our news-obsessed world. Being a democratic kind of place with quite a lot of countries and, therefore, quite a lot of elections, Europe generates a lot of political news.

In the end, politics only matters from an investment point of view when it poses a genuine threat to financial markets. In reality, Europe has seen far more market-friendly political outcomes than many commentators have predicted in the recent past. Note that France elected President Emmanuel Macron (who is promoting a market-friendly reformist agenda) and rejected the divisive, destructive Marine Le Pen. Looking forward, we work from the maxim that it is important to distinguish between the probable and the merely possible, which leaves us relatively relaxed about the market implications of political trends within the future European Union of 27 states.

Buy the empty room?

So where to concentrate within the market? Years ago a broker made a comment which still rings true to us: "Buy the empty room when you go to an investment conference." In other words, those meetings with company management which few can be bothered to attend are often the most interesting. The "full rooms", i.e., companies with over-developed fan clubs, are often already over-represented in portfolios and indices alike, meaning that they could well be past their "sell-by dates" as investments.

There have certainly been times latterly when our portfolios have felt like the owners of an "empty room", with what we find attractive being well away from the main focus of the market. It's not a question of being awkward and contrarian just for the sake of it: we are simply trying to position our portfolios for the next phase in the markets to protect and enhance our clients' interests. We are seeking the best investment outcomes based on our view of how the European investment world develops from here. In 2016 we saw that sector rotation – a change in stock market leadership – can be powerful when it materialises, and as we currently see a significant bout of sector rotation as highly justified, we want to be ready for it.

We see value in out-of-favour sectors

We are valuation-focused portfolio managers – not strictly "value" or "growth" – and as such we'll look at most any investment. We don't particularly like these labels, but they can be very useful verbal shorthand. At the time of writing, we see striking valuation opportunities in out-of-favour sectors at the value end of the spectrum. In Europe, the prime examples are energy, telecoms and financials – especially banks. There are also sectors which we want to keep well away from – typically many of those which have attained "bond proxy" status in recent years. To our minds, some have become eye-wateringly expensive as a result. Consumer staples such as food and beverage stocks are cases in point. These are often companies with extremely strong and respectable track records, and while it is easy to understand their market image, it's important to remember that a good company does not necessarily make a good investment.

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No matter how wide the divergence in valuations between sectors in our market, this is not just a valuation call. There are good reasons to believe that the operating performance of European integrated oil companies, telecoms and banks will improve from here. To cite just three factors at play: Management attention to capital allocation and return on capital in energy is much improved, there are incipient signs of a return to long-absent growth in telecoms, and bank incomes are rising while costs are falling.

Trouble ahead for bond proxies?

Meanwhile, in the much-loved and highly rated bond proxy end of the spectrum, we see trouble brewing: Organic top-line growth has often been disappointing; attempts to buy growth through mergers and acquisitions can pressure returns on invested capital; bond yields are likely to rise from very low current levels given the resilience of eurozone economic performance; a bit of inflation may be returning and there is a whiff of central bank regime change in the air.

It's always tricky to judge exactly when the mood music in the market will change, but we believe the case for meaningful sector rotation is very strong and, as active portfolio managers, we want to be prepared for it. We look forward to welcoming more people to our empty room.

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