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European equities: The current winners

Cédric de Fonclare, fund manager of the Jupiter European Opportunities SICAV, said any fillip to European markets triggered by an expected Spanish bailout is likely to be short lived. A tricky earnings season points to near-term volatility while concern about sluggish European growth highlights the need to invest in firms with strong balance sheets, good cash flow and excellent earnings visibility.

European equity markets are likely to react favourably when the Spanish government finally seeks assistance from fellow eurozone members to shore up its finances. It will be viewed as another step towards reducing the amount of uncertainty that has weighed so heavily on Europe since early 2010 when Greece requested its first bailout. There is evidence* that international investors, and to a lesser extent UK investors, have proved more willing in recent months to put money to work in the region but they do so after a long period of being very underweight European equities. Speaking to European-based investors, the story is rather different. They have traditionally shown a smaller appetite for stock investing than their American or British counterparts and the current macro-economic climate has done little to change this situation.
What is clear is that the decisions taken by Europe's politicians and central bankers to tackle the ongoing debt crisis so far are merely stop-gap measures. The fundamental issues behind the crisis remain and there are no easy shortcuts to resolving them. Eurozone countries have to bring down their levels of debt and doing so will take a long time. Austerity measures will have to be imposed and these will affect European growth rates.

Earnings misses may boost volatility
As a first step, therefore, it is vital that an expectation of sluggish economic growth should underpin any investment strategy for Europe. Second, European equity investors should be aware they are facing some short-term challenges. Upcoming earnings reports are likely to spark some volatility on the markets as profits come in below forecast and guidance is weaker than expected. When European firms gave out their guidance earlier this year, many of them were factoring in an economic recovery in Asia, particularly in China in the second half. This recovery has failed to materialise and there is insufficient growth in other regions of the world to compensate. Southern Europe remains weak and its weakness has been broadening out to the rest of core Europe. One bright spot has been North America but growth there has not been fast enough to make up for the slowdown in Asia's previously fast-growing economies. We believe firms have been too optimistic about 2013 and previous forecasts of double-digit earnings growth are unlikely to be met given the economic climate. For some investors who missed the recent rally – the Euro Stoxx 50 is up over 20% from its June lows – any sell-offs could be used as an opportunity to jump into the market.

"Winners" in a low-growth environment
This combination of short-term volatility and a low growth environment call for the skills of talented stock pickers when it comes to selecting European stocks. European firms best positioned to flourish are those which have a healthy balance sheet and good cash flow that will help them finance their growth. They need to have the capacity to be able to allocate capital to fast growing regions of the world. They need to ensure they derive a significant part of their revenues from outside the sluggish European economies. German software group SAP is a good example of a company with these characteristics. On a smaller scale, the duty

free specialist Dufry, while not a fashionable name, has the earnings visibility that makes it potentially attractive in the current investment climate

Another trend is the renewed appetite among firms for outsourcing activities and services. Companies that have benefited from this move include certification companies like SGS and Intertek.

What to avoid

On the other hand, we believe it is best to avoid sectors that are under political scrutiny or can be tapped by cash-strapped governments to help reduce their deficits. Banks, utilities and telecom companies are three of the most obvious targets.

Another theme has been to buy this year's laggards – mainly the shares of Southern European firms – but this is a trade that has largely run out of steam, in our view. If you take a closer look at forward P/E ratios, Spain has become nearly as expensive as Germany. At the same time, uncertainty surrounding the Spanish economy and the growth profile of some of these Spanish names continue to make them structurally less attractive than many German companies.

Outlook for European stocks

Looking ahead to the fourth quarter and 2013, I expect to be operating in an environment still very much driven by the political response to the eurozone crisis. Nevertheless, I do expect to see international investors increase their purchases of European stocks after being structurally underweight in the region for quite some time. Given the uncertainty about the earnings outlook, we are likely to continue to skew our portfolio in favour of businesses that have abnormally high levels of visibility and good growth prospects. For investors who remain on the fence about Europe, it is important to remember that European stocks are trading at a reasonable discount to their historical valuations, with the added appeal of good dividend yields and solid balance sheets.

*BofA Merrill Lynch Fund Manager Survey
http://newsroom.bankofamerica.com/press-release/economic-and-industry-outlooks/bofa-merrill-lynch-fund-manager-survey-finds-comeback-s

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