MARKET INSIGHTS

The opportunity in European equities

May 2013

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Introduction

Since the financial crisis of 2008, European economies from the UK to Greece have suffered from an extended period of slow growth and recession. When the elevated debt levels of some European nations were exposed in 2008, the continent found itself in financial turmoil, with some market pundits proclaiming that the only viable solution would be to abandon the euro. While the European Monetary Union (EMU) currently remains intact, the events of the past few years have resulted in alarmist newspaper headlines and investor uncertainty, with politics - rather than underlying corporate earnings or valuations - driving markets.

In this paper, we look at why we believe the EMU will successfully begin to emerge from the crisis, with progress already made on fiscal and economic integration to complement the monetary union. Macro fundamentals have turned an important corner and will be more supportive of European equities going forward. However, a rising tide may not lift all boats equally, and we believe the next few years are likely to see more meaningful dispersion between 'winners' and 'losers', as investors cast a more discerning eye towards security-specific fundamentals now that the panic-inducing risk-on, risk-off swings appear to be behind us.

The ECB is committed to the euro

European equity markets have been hit by volatility and uncertainty over the past few years, as they have had to grapple with what appeared to be a very binary outcome to the crisis: the end of the euro as we know it, or… not. While the crisis has not been solved, per se, it is our view that markets do not need a resolution to the financial crisis to move higher. What they do need are some assurances that the crisis is *contained*. This is where the European Central Bank (ECB) comes in.

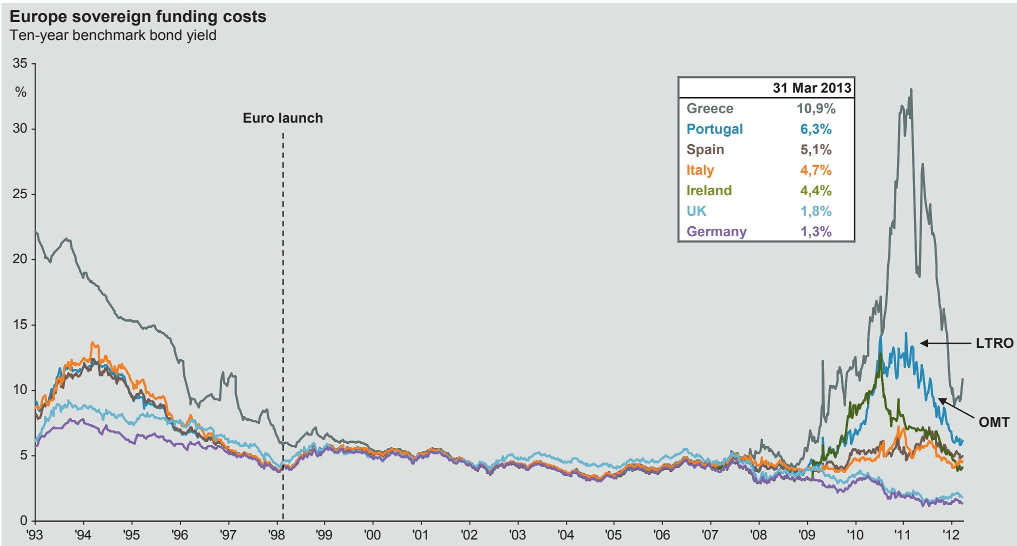
The ECB, led by Mario Draghi, has promised to do 'whatever it takes' to preserve the euro. Initiatives such as the Securities Markets Programme (SMP), long-term refinancing operations (LTRO), and Outright Monetary Transactions (OMT) have helped to stabilise the banking system, lower sovereign borrowing costs and reduce the intensity of the crisis. Following the ECB's May 2013 announcement, the key policy rate is at a record low of 0,5%. However, the ECB has more tools available should they be needed, including lowering the key policy rate further or relaxing collateral requirements to improve bank liquidity.

J.P.Morgan Asset Management

In particular, the introduction of the OMT programme – under which the ECB has promised to buy unlimited quantities of the bonds of qualifying countries in order to stabilise the market – has provided a powerful psychological backstop. Importantly, the programme is yet to be used, but its mere existence has boosted confidence in the willingness and ability of policymakers to prevent a breakup of the currency bloc. As shown in **Exhibit 1**, bond yields throughout the region have compressed materially since Draghi's July 2012 'Bumblebee' speech. For example, after starting 2012 at 31,7%, Greek ten-year bond yields ended the year at 10,2%, while Italy and Spain are enjoying ten-year borrowing costs in early May 2013 of 3,8% and 4,1% respectively, close to the levels they traded at prior to the crisis.

• Interventions by the ECB have had a powerful calming effect on investor sentiment, as demonstrated by the fall in peripheral bond yields following the LTRO and OMT announcements.

Exhibit 1 | Europe government interest rates



Note: The ECB announced the second round of Long Term Refinancing Operations (LTRO) in February 2012. The Outright Monetary Transaction (OMT) programme was formally described in September 2012. Source: Tullett Prebon, FactSet, J.P. Morgan Asset Management.

Improving fundamentals and structural reform

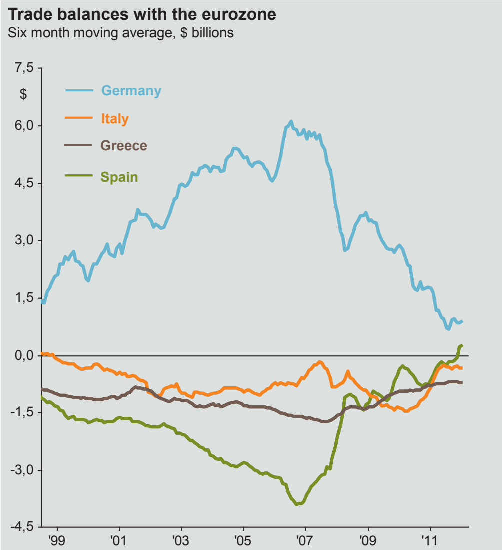
The downward move in bond yields in peripheral eurozone economies reflects not only ECB intervention, but also tight fiscal policies and supply-side reform in the highly indebted countries. This, in the absence of floating exchange rates, is contributing to a necessary rebalancing within the eurozone.

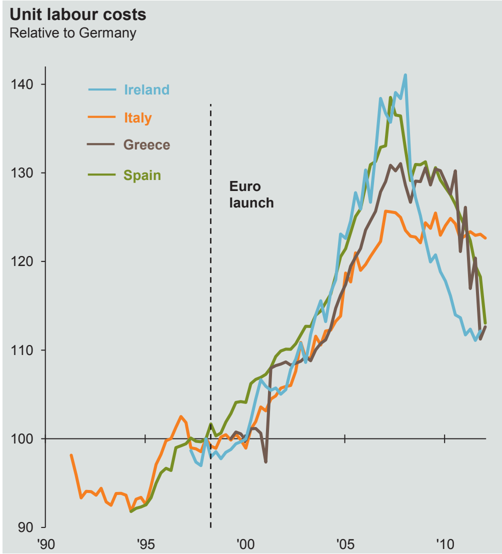
As **Exhibit 2** (left-hand chart) shows, before the crisis, Germany had run a strong trade surplus for years, an important pillar of economic vitality. Peripheral economies, meanwhile, ran persistent trade deficits. The result was that Germany was continually being enriched by selling its goods to its neighbours, while countries like Spain, Italy and Greece, as large consumers of German goods, continued to send their money abroad. Since the onset of the crisis, however, a deep recession and harsh austerity have contributed to a decline in imports by the periphery, driving both a fall in Germany's trade surplus and an improvement in the periphery's trade deficits.

As the right-hand chart shows, labour costs in the peripheral countries have been woefully uncompetitive relative to Germany since the formation of the euro, although this dynamic appears to be changing. In part, the improvement has been a function of lower labour costs, which have fallen due to high unemployment and supply-side reforms. While these reforms are ongoing and certain countries have enjoyed more success than others, extending the pensionable age of workers, making hiring and firing easier, and reforming pensions and other welfare payments have all contributed to this changing dynamic.

- *The trade imbalances created by the EMU are unwinding. In the absence of currency flexibility, internal devaluations are taking place as wages in the peripheral economies fall in cash terms. This has supported the periphery's trade accounts, while lower imports from the core economies have dented Germany's trade surplus.*

Exhibit 2 | Europe structural imbalances





(Left) Note: Latest data January 2013. Source: Eurostat, J.P. Morgan Asset Management. (Right) Note: Latest data 3Q12. Data rebased to 100 at 4Q98. Unit labour cost measures the average cost of labour per unit of output and is calculated as the ratio of total labour cost to real output. Source: ECB, J.P. Morgan Asset Management.

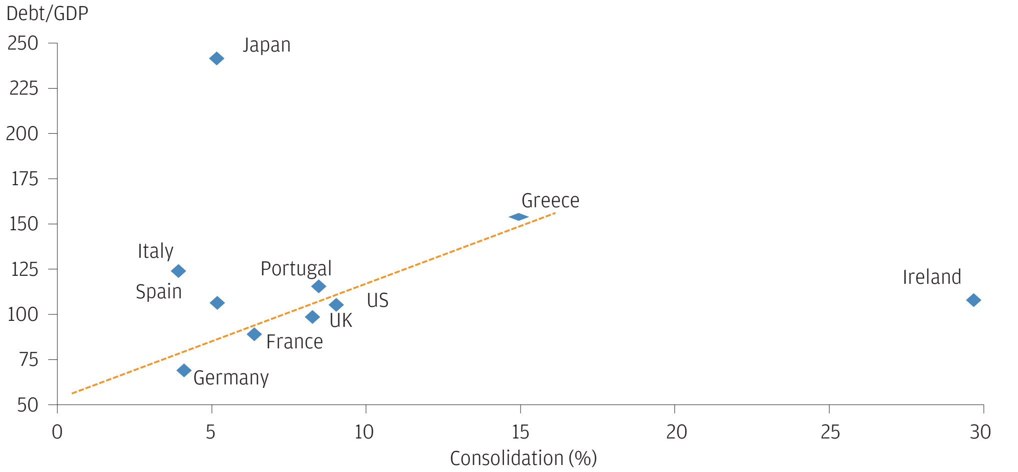
Furthermore, efforts have been made to extend the tax base in the peripheral economies. This includes naming and shaming the elite who are found to be hiding money abroad, as well as the better use of technology in tax offices.

As severe as the recession has been, a more balanced trade account and better tax collection are important building blocks for the recovery in the EMU and Europe in general.

Less austerity ahead?

While it is clear that structural reform is needed throughout much of the European economy, the usefulness and validity of austerity as a means of achieving it have been vigorously debated. To its critics, austerity policies have meant that the weakest countries in Europe have been left to wither, forced to meet aggressive deficit targets by cutting spending. Exacerbating the problem is the fact that the heaviest doses of austerity have generally been administered to the sickest of patients. As seen in **Exhibit 3**, while the pace of austerity (or 'fiscal consolidation', as policymakers have less toxically dubbed it) for most countries has not been extreme, there has been a clear relationship between the amount of fiscal consolidation needed and the amount of debt the country has outstanding.

Exhibit 3 | Level of outstanding debt and degree of fiscal consolidation



Note: Consolidation defined as change in budget deficit-to-GDP ratio from the highest level between 2000 and 2013 and forecast level in 2017. Debt-to-GDP level is forecast as at 2017. Source: IMF WEO October 2012 edition, FactSet, J.P. Morgan Asset Management.

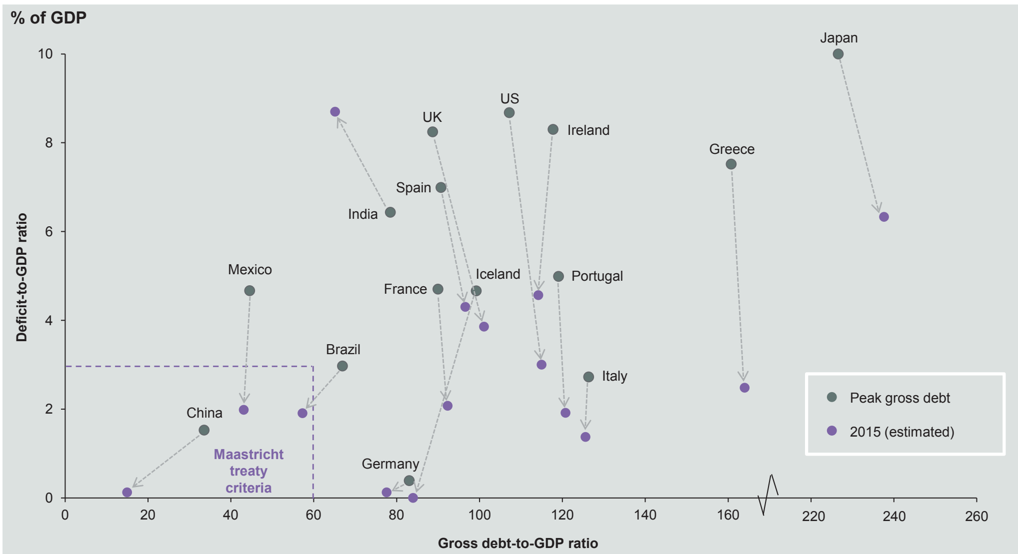
While this pain has not come with some gain, as is illustrated in **Exhibit 2**, some have argued that the results of fiscal consolidation have been less inspiring.

As **Exhibit 4** shows, many countries have been able to reduce their annual deficits significantly, or are on track to do so by 2015. Though this represents progress, it is also clear that it has not yet made a large impact on overall debt-to-GDP ratios. This is because the outstanding debt has been accumulated over many years and takes time to reduce, and because austerity initially contributes to weaker GDP growth (and sometimes recession), which in turn limits the size of the denominator in the debt-to-GDP ratio.

As an example, say Country X had a deficit of EUR 10, and outstanding debt of EUR 100. Then, say that aggressive spending cuts resulted in a reduction of the annual deficit from EUR 10 to EUR 5. The problem is that the EUR 5 deficit remaining only gets added to the existing mound of debt, resulting in total debt of EUR 105 – an outcome achieved on the back of lower GDP.

• The limits of austerity: efforts to reduce budget deficits (y-axis) often make little impact on debt-to-GDP ratios (x-axis), much to the frustration of policymakers.

Exhibit 4 | Deficit and gross debt by country



Note: The chart uses gross debt-to-GDP ratio as this is one of the three criteria stipulated in the Maastricht Treaty. The peak is taken as the highest gross debt-to-GDP in the period 2006 to 2012 with the corresponding deficit-to-GDP figure for that year. The peak year for each country is: Germany, France, UK, Spain, US, Ireland, Portugal, Italy, Greece and Japan 2012; Iceland 2011; China 2010; Mexico and Brazil 2009; India 2006. Source: IMF WEO October 2012 edition, FactSet, J.P. Morgan Asset

Many economists and policymakers, not least the International Monetary Fund (IMF), now argue that the pace of austerity needs to be flexible to ensure that it does not restrict growth. And now that anxiety levels are lower, and there is far less risk that markets will punish any backsliding by pushing up interest rates, it is reasonable for the pace of austerity to be slowed as long as the end goals are maintained.

Recent comments by key leaders suggest that the high tide of austerity has passed, with even UK chancellor George Osborne promising 'flexibility' in his deficit reduction plans. In our view, it is also probable that Angela Merkel (who has favoured the implementation of austerity throughout the crisis) may begin to embrace more pro-growth policies. For example, during the recent trip to Germany by Italy's newly elected prime minister, Enrico Letta, Merkel noted that 'budget consolidation and growth need not be contradictory.' Taken together, these factors suggest that investors should be considering what the end of austerity may mean for capital markets across Europe.

Confidence, valuations and the end of risk-on, risk-off

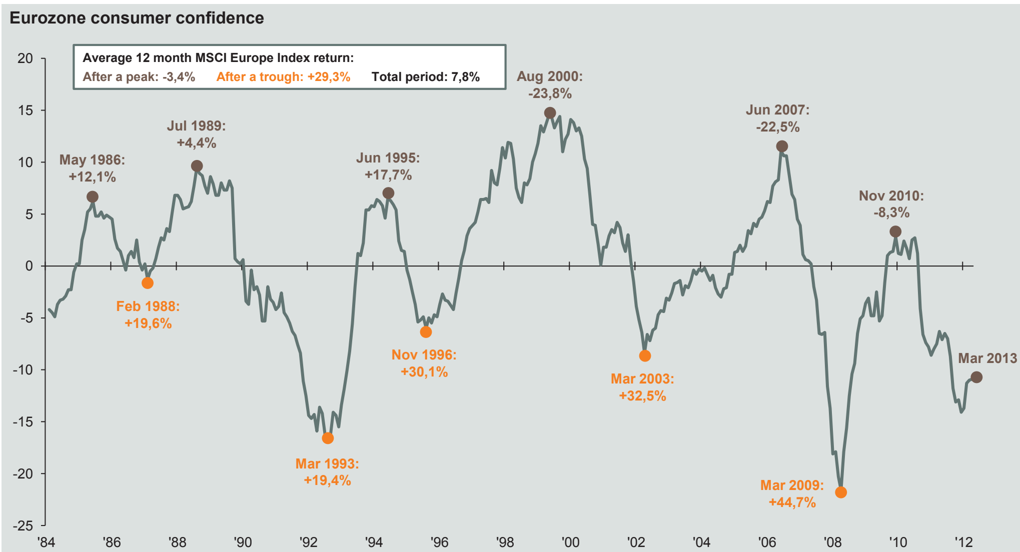
If the eurozone crisis does prove to be contained and the current policy of austerity begins to wane, the emergence of a stronger EMU seems realistic. And as investors begin to recognise that fundamentals in the eurozone are improving, we could see equity prices continue to move up as the appetite for risk assets returns.

Sir John Templeton once said, 'Bull markets are born on pessimism, grown on scepticism, mature on optimism and die on euphoria.' There is a lot of truth in these words, and from our experience some of the strongest equity returns follow the most extreme troughs in sentiment, and vice versa.

• Weak consumer confidence has often proven to be a helpful contrarian indicator for stock market returns.

Exhibit 5 shows the 12-month returns in the periods immediately following both highs and lows in confidence. On average, markets surged by double digits in the year following historic lows in confidence, while returns were more mixed - and often negative - when investors bought with confidence.

Exhibit 5 | Consumer confidence and the stock market



Note: Peak is defined as the highest index value before a series of lower lows, while a trough is defined as the lowest index value before a series of higher highs. Subsequent 12-month MSCI Europe Index returns are price returns only, which excludes dividends. Total period return is the average 12-month rolling return. Source: European Commission, FactSet, J.P. Morgan Asset Management.

To be clear, this is not meant to suggest that investors should try to time the lows in sentiment, and then pile into equities. However, investors may do well to appreciate that instincts often tell us to do the wrong thing, at the wrong time. Today, low levels of consumer confidence may keep investors away from markets, but history shows this could be a mistake, especially as confidence measures slowly begin to recover, as they are now doing in Europe.

The role that confidence plays in capital markets

Not only can confidence be a fairly reliable contrarian indicator, but history shows a strong correlation between confidence and security prices. **Exhibit 6** shows the high degree of correlation between price-to-earning (P/E) multiples – a measure of the premium investors are willing to pay for earnings – and confidence (in the top chart). A similarly strong relationship is shown between confidence and bond yields (bottom chart).

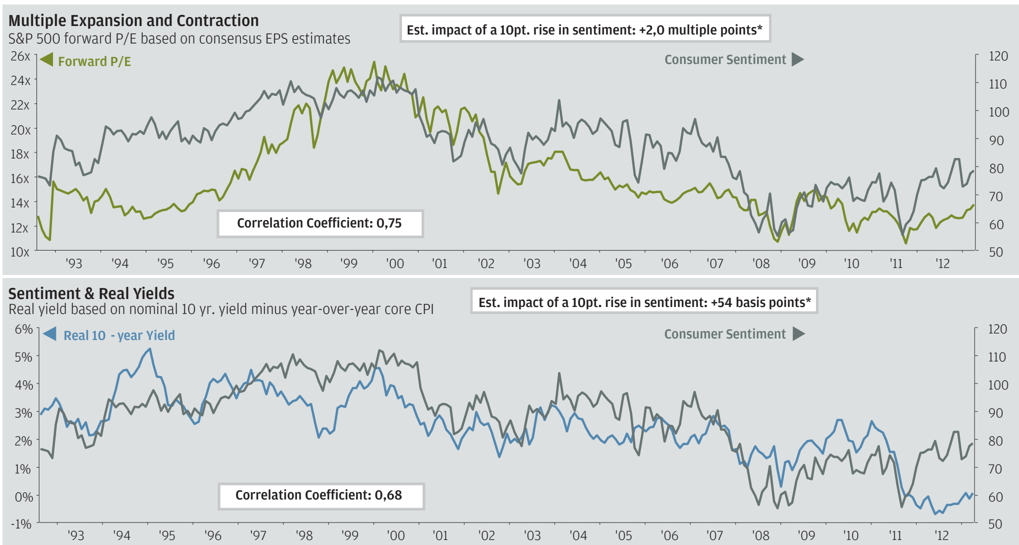
Perhaps the best example of this relationship was when equity valuations became enormously stretched during the tech bubble in the late 1990s, a period that ultimately came to be described by former US Federal Reserve chairman Alan Greenspan as 'irrational exuberance'. Conversely, low confidence, risk aversion and a flight to quality have contributed to the suppression of P/E multiples and bond yields in recent years.

Looking forward, improving confidence in the eurozone could play an important role in driving asset prices and valuations. Today, with some markets approaching or reaching multi-year highs (DAX, FTSE, S&P 500), it is important to bear in mind that low-but-rising confidence provides plenty of fuel for risk assets going forward, and that new highs are not necessarily the same as new peaks.

Furthermore, the deeply entrenched European savings culture means that there is capital available in the medium term to support investment.

• Confidence has been an important driver of capital markets behaviour, both in equities and fixed income. The tech bubble is a good example of how unbridled optimism skews returns and stretches P/Es.

Exhibit 6 | Confidence and the capital markets



Source: (Top) Standard & Poor's, FactSet, J.P. Morgan Asset Management. (Bottom) U.S. Treasury, BLS, University of Michigan, J.P. Morgan Asset Management. Price to Earnings is price divided by consensus analyst estimates of earnings per share for the next twelve months. Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core inflation for that month. *Estimated impact based on coefficients from regression analysis. Data are as of 3/31/13.

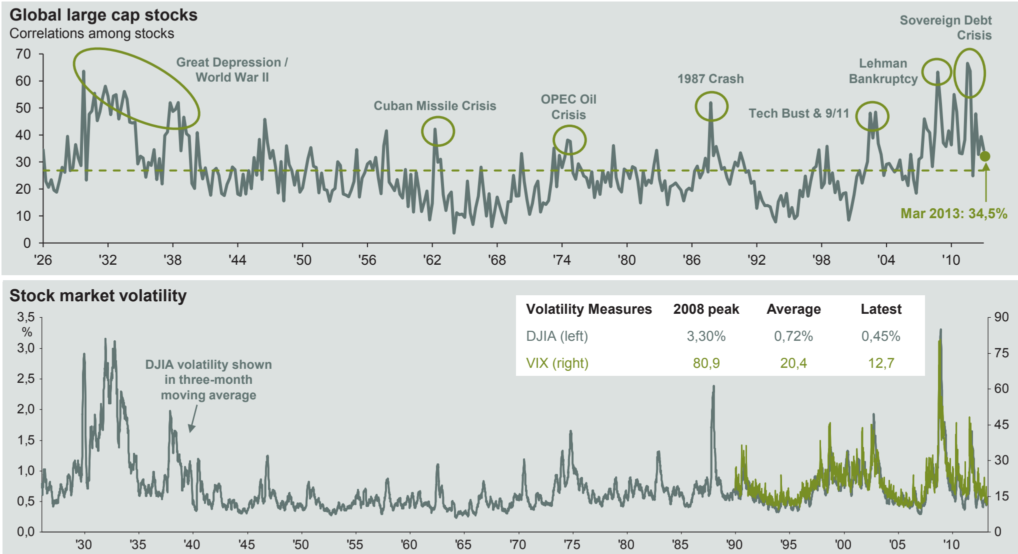
The end of risk-on, risk-off, and why passive investors may be left behind

Global capital markets were hit by violent swings and extreme volatility in 2009, 2010 and 2011. This volatility was well in excess of what would be considered normal, and the uncertainty it spawned resulted in extreme levels of risk aversion. As **Exhibit 7** shows, equity correlations tend to spike in periods of excessive uncertainty and volatility, which, generally speaking, have coincided with significant historical events, including the September 2001 terrorist attack on the World Trade Centre, the failure of Lehman Brothers and, most recently, the European sovereign debt crisis.

During the crisis, investors around the world scrambled to unload risk assets, opting to hold cash while the storm engulfing markets raged on. This abandonment of risk assets resulted in prices moving down simultaneously, as nearly everything with a price moved in the same direction (down). For portfolio managers focused on fundamentals, this hot-potato selling made for a very difficult environment.

• *As correlations between global large cap equities have declined, there has been greater scope for stockpicking and increased focus on market fundamentals.*

Exhibit 7 | Equity correlations and volatility



Volatility Measures	2008 peak	Average	Latest
DJIA (left)	3,30%	0,72%	0,45%
VIX (right)	80,9	20,4	12,7

(Top) Note: Capitalization weighted correlation of top 750 stocks by market capitalization, daily returns, 1926 – 2013. Source: Empirical Research Partners LLC, Standard & Poor's, J.P. Morgan Asset Management. (Bottom) Note: DJIA volatility is represented as three-month moving average of the daily absolute percentage change in the Dow Jones Industrial Average. Source: CBOE, Dow Jones, FactSet, J.P. Morgan Asset Management.

Today we are seeing a very different situation. With the confidence boost from the ECB acting as a strong sedative, the violent risk-on, risk-off swings that rocked markets in 2009, 2010 and 2011 have abated, and, as evidenced by lower correlations and higher dispersion, investors have begun to refocus on fundamentals. This has produced a more fruitful environment for fundamental-driven equity investors, and a continuation of this trend suggests that investors may do better to participate in Europe's recovery selectively.

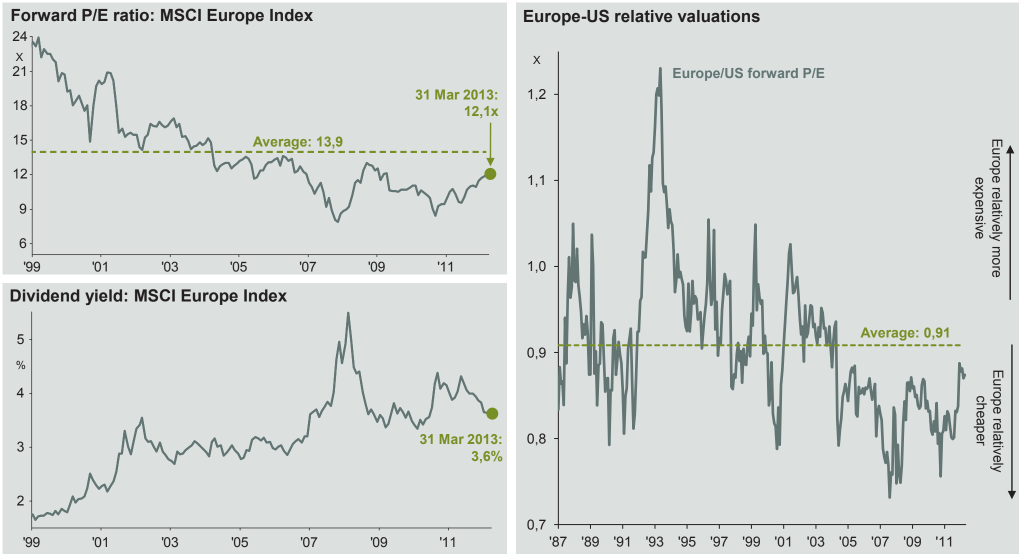
Valuations in line with historical average, cheap compared to US

Also generally supportive of European equities are valuations. To be sure, P/Es in Europe are not at the same 'screaming cheap' levels seen at the height of the crisis in late 2010, as an improved macro backdrop has allowed for a healthy ascent in key indices. But with today's P/E multiples trading just shy of the long-term average, as seen in **Exhibit 8** (top left), European stocks are anything but expensive.

European stocks look particularly interesting on a dividend yield basis, given the historically low level of yields currently available on government bonds and other traditional income-generating asset classes (bottom right). At the aggregate index level, there is still a slight valuation discount being applied to Europe relative to the US, which could help relative returns in the medium term (right).

• *Valuations for European equities look fair by their own history, and attractive when compared to core government bonds and the US stock market.*

Exhibit 8 | Europe equity valuations

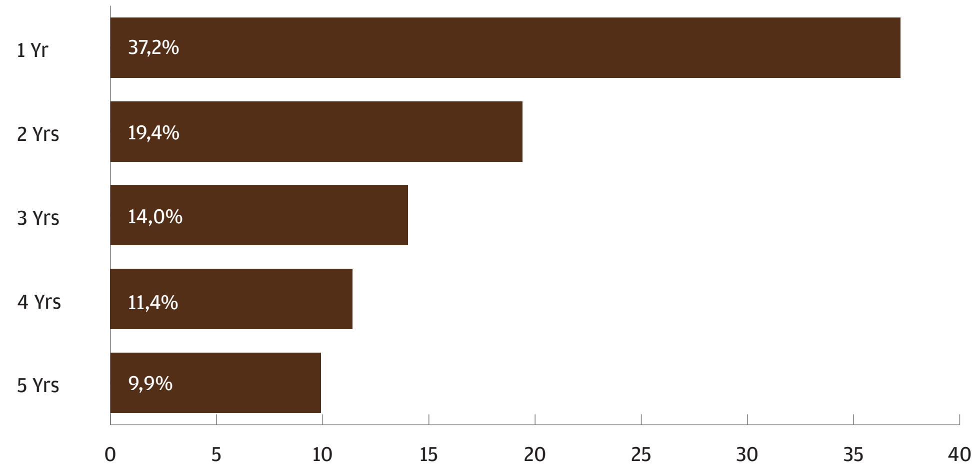


The Europe-US relative valuation shows the forward P/E of the MSCI Europe Index divided by the forward P/E of the MSCI USA Index. Source: MSCI, FactSet, IBES, J.P. Morgan Asset Management.

Finally, even if it takes years for markets to recover the rest of their financial crisis-related losses, investors stand to enjoy relatively strong returns along the way. **Exhibit 9** illustrates the averaged annualised total return investors would achieve, mathematically, in a variety of different scenarios. For example, if the MSCI Europe Index were to regain its pre-crisis peak five more years from now in 2018 – *a full decade after the onset of the crisis* – investors would stand to earn nearly double-digit annualised total returns.

Exhibit 9 | MSCI Europe Index: Hypothetical return scenarios

Analysis as of 30 April 2013, implied average annualised total return achieved given a return-to-peak over specified period.



Note: for illustrative purposes only. Dividend yield is assumed to be 4% per annum. Source: J.P. Morgan Asset Management.

Other considerations

It is also important to remember that for all the weak growth and noise caused by austerity and fear of an EMU breakup, Europe is home to a large number of multinational companies that are partially insulated from weak domestic demand thanks to exports. A strong euro may dent export growth, but many sectors (eg luxury goods and high-end industrial components) compete on quality rather than cost, and as a result are relatively immune to euro appreciation. This pushes European companies toward higher return businesses, and because Europe is especially strong in high-end consumer goods, the corporate sector benefits disproportionately from growth of the global middle class.

Among domestically focused stocks, meanwhile, investors can find defensive sectors offering good dividend yields that could grow going forward (useful for income seekers), along with some cyclical sectors that appear oversold on misguided fears that the European economy will never recover. Furthermore, the balance sheets of these companies are quite healthy, which should support not only dividend payments, but also an increase in share buybacks.

There are a number of other reasons to be optimistic about Europe: inflationary pressures have softened, leaving more room for monetary easing, while extremely difficult financial and credit conditions appear to be poised for improvement. And, as has happened in the US, pent-up demand for big-ticket items like cars and homes will likely contribute to growth going forward. Moreover, countries outside the EU and the eurozone are still applying to join, which will increase the size of the European consumer market. In addition, when European voters have been given a choice about the euro, they have shied away from the prospect of departure, and most indebted countries know that they benefit from a lower overall cost of capital and lower inflation than they would if they went back to legacy currencies.

A word on risk

Although there are persuasive reasons for investors to embrace European equities, as with all investments, doing so does entail some risk. Concerns about a breakup of the euro have begun to subside in the wake of Draghi's Bumblebee speech and the ECB's OMT announcement, but scepticism about the viability of the common currency and the ability of policymakers to forge ahead with plans for a more robust and integrated banking system remains. A key risk here is that anti-euro sentiment peaks before the European economy is out of the woods, and that the sceptics gain power – or, that this scepticism gains sufficient momentum to prevent any sort of cooperation between the sovereigns that make up the eurozone. Although the probability of these scenarios seems substantially reduced at the moment, paying attention to the impact of scepticism on the political sphere, as well as the potential for policy missteps, could be a worthwhile exercise for investors.

Summary

As the fear of an EMU breakup subsides and Europe continues to make progress with structural reforms, long-term investors stand to benefit from a European equity market that offers attractively priced opportunities underpinned by low core government bond yields, corporate earnings growth opportunities from exports and an eventual recovery in confidence at home.

The market recovery in Europe will not be smooth or without setbacks, and investors should remain well diversified to cushion the bumpy ride. But the inevitable flare-ups and anxiety-inducing headlines about austerity and the future of the euro should not distract long-term investors from the attractive fundamentals and less uncertain backdrop, as times of great pessimism have historically presented some of the greatest investment opportunities.

Finally, after the tumultuous last few years, we see markets developing an ever more discerning eye for fundamentals, and believe investors should participate with the understanding that a rising tide will not lift all boats equally. We would expect a greater dispersion between 'winners' and 'losers' over the next 12-24 months, and our conviction remains that an active approach is best.

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