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# IN THE EUROZONE



## COMMITTEE CHAIRMAN

Adam Lewis

EDITOR  
FUND STRATEGY



Three years on from talk of the possibility of the euro collapsing amid an all-engulfing eurozone financial crisis, investors are generally feeling bullish again.

After three consecutive years of double-digit downgrades in European earnings, 2014 is expected to see upgrades as domestic earnings growth builds traction.

Not only has the eurozone been the most preferred global region for the past five months, according to Bank of America Merrill Lynch's January survey, but the peripheral countries – those hit most by the crisis – are the ones attracting a lot of interest. In January, Greece's Purchasing Managers' Index returned to growth for the first time since August 2009. Some experts even think the country could exit recession this year.

The news is equally good for other PIIGS (Portugal, Ireland, Italy, Greece and Spain) economies, with Italy and Spain witnessing robust growth in output and order books. According to pre-market indicator publisher Markit, these are all signs that even the most troubled euro member states are returning to growth. Indeed, Barry Norris, chief investment officer at Argonaut Capital Partners, recently upped his overweight to the region with the view that we may be about to enter a period of exceptional returns from southern European stockmarkets. He started investing in Greek banks in December.

Hermes chief economist Neil Williams, this month's independent panellist, tackles some of these points, while I ask our other panellists: Is Europe as cheap as many claim it to be? Can we assume that a euro collapse is no longer on the cards? And, within Europe, do they see new opportunities in the countries on the periphery of the more developed markets?

Also, which regional funds in particular are they using?

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Mike Deverell

INVESTMENT  
MANAGER,  
EQUILIBRIUM  
ASSET  
MANAGEMENT

Many people view Europe as cheap relative to the US but this is only because the US looks quite expensive. Based on both past and forward price/earnings ratios, Europe looks fair value at best. Earnings growth has been anaemic, with little in the past year, although it picked up slightly at the end of 2013. As economies in Europe recover, companies should improve and earnings should start to grow, which could move the market forward. However, risks remain and I do not believe the eurozone crisis is behind us. Very little has been done to solve underlying issues such as the required integrated fiscal policy or banking union. I would not buy a European index tracker right now but good fund managers should still be able to find the odd bargain. We like truly active funds such as BlackRock European Dynamic, whose manager is happy to make big geographical calls or change strategy depending on the outlook. Some parts of the market, notably quality defensive stocks, look very expensive. I would avoid funds with a quality bias for now.

I cannot get excited about European Union equities when I continue to be cautious to bearish on the S&P and FTSE. The euro seems to keep strengthening, which is good long-term but not right now. Import costs will fall, making exporters more competitive, but it is like a tanker turning around. And that is only in Germany; nearly everywhere else, the state keeps competitiveness down through dreadful employment practices, huge state intervention and other anti-capitalist regulations. Most of the EU is a basket case and we spend little time on it. France is the worst. Why anyone would start a business there I cannot imagine and the same applies to most of the southern EU. As for stocks, wake me up after either a global stock crash or the break-up of the euro. French and German banks still hold huge debt of southern EU states and fragile emerging markets. But I am bullish on German bunds despite not investing in them, as other areas interest us more. As the global deflation case builds, it should be strongly positive for bunds this year and perhaps beyond.

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Jonathan Davis

MANAGING  
DIRECTOR,  
JONATHAN  
DAVIS WEALTH  
MANAGEMENT

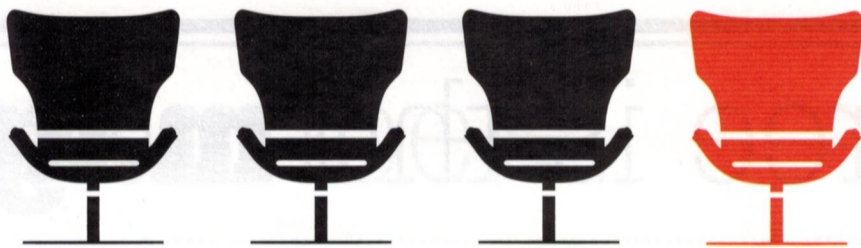
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James Calder

HEAD OF  
RESEARCH,  
CITY ASSET  
MANAGEMENT

Europe has been through the wringer and still faces huge challenges that go to the heart of monetary union. A break-up of the euro is a possibility without structural change but the political will to ensure survival is present for now. The region does not lack opportunities and a manager who is unconstrained by country, sector and market cap minimums can find good companies that have survived the financial crisis. These companies have taken extreme action to protect themselves, emerging with operational leverage. They may also benefit from diminished competition in their sector or region. Funds in this category include JPM Europe ex-UK Dynamic and a truly small cap fund, Ignis European Smaller Companies. Peripheral Europe is producing some good ideas but very selectively. We should also remember the bright spots in Europe – not just Germany but the Nordics too. To say the region is generally in poor condition is too simplistic. In the third quarter of 2013, we increased our weight, where appropriate, to take advantage of perceived opportunities.



**The worst of the euro crisis is over and even the peripheral economies are growing. But Europe's still not home free**

After the euro crisis erupted in 2011, the ECB had its work cut out to restore market confidence. Some are now tempted to pronounce the end of the crisis, particularly with peripheral bond yields at much lower levels and a return to economic growth for most of the region. Leading indicators and consumer confidence surveys are also improving. A fund manager recently told us that as long as Angela Merkel and Mario Draghi stay in power, there is no reason for further panic. But after strong equity returns and positive fund inflows, many potential investors wonder if they have missed out. The market is no longer cheap, although relative to US equities it still has attractions. Beta players should take a back seat as economic growth promotes further dispersion in share prices. Fund sector averages have already done well, fuelling the active versus passive debate. We remain agnostic and use various approaches. We favour tried-and-tested stockpickers such as Alex Darwell (Jupiter European) and Paul Wild (JOHCM Continental European).

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**John Husselbee**

**HEAD OF MULTI ASSET, LIONTRUST**

Our concern remains that the euro crisis is entering its second, more sinister, phase where the macro strains of the periphery increasingly wear on the core countries footing the bill. With its back still turned on the reality of deflation, the European Central Bank will continue to prevaricate over new stimuli such as quantitative easing. However, core inflation, at just 0.8 per cent year-on-year, is already at a record low.

Our analysis shows the extent to which the eurozone's underlying problem – a monetary union devoid of sufficient economic union – is being addressed. We use the OECD's estimates to 2013 of a country's manufacturing unit labour costs relative to its main trading partners'.

Germany is benefiting by directing its more competitive exports outside the zone, such as to China and central Europe. But France's competitiveness has been hit since the euro crisis and looks to be prolonged by lower productivity, labour inflexibility and higher taxes.

This shows that shifts in individual competitiveness remain too disparate. The biggest winner is still Germany, although most other members have experienced a net deterioration in their position with the euro. The good news is that, after four years of austerity, Spain and Italy's deterioration is correcting.

But there are more tensions to come. France's debt position is high and deteriorating; its net debt-to-GDP will climb to 76 per cent in 2014 from 45 per cent 10 years ago.

With others prolonging QE, the ECB may ultimately have to follow suit. Otherwise, some of the growth and tax benefits to Italy, Spain and others from their long overdue improvement in competitiveness may end up being eroded by a stronger euro.

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**Tim Cockerill**

**HEAD OF COLLECTIVES RESEARCH, ROWAN DARTINGTON**

Europe is slowly dragging itself towards a brighter future but it is a painful process. France urgently needs structural reform but change seems distant. At the periphery, signs of economic life suggest that the worst may be over but full health is years away. The euro has weathered the worst of the storm and although credit is contracting and further bank de-leveraging is needed, the likelihood of the euro collapsing has passed. However, things are not overly promising. Europe has always been a market in which to pick stocks; it is deeper than the UK and home to many world-class companies as well as small firms that focus on the domestic economy. While European markets may not be cheap at the top level, managers say they can still find value. When looking at the whole picture, the outlook is unclear, so funds with a quality bias can offer a degree of safety. If the economic outlook picks up and with it market sentiment, these funds are likely to lag. But for now I would rather play safe. Jupiter European remains our first choice.

Europe is now out of recession with GDP likely to turn positive in 2014.

Stronger growth in Germany and more stimulative fiscal policies from the ECB should assist further, alongside stronger US growth. The latter should benefit the eurozone and, more importantly, European companies, especially exporters. But growth will be uneven, with the likes of Greece, Ireland, Portugal and Spain facing an upward struggle after painful austerity programmes. Conversely, France is suffering from a big fall in manufacturing, a soaring public debt problem and the president's very aggressive tax agenda, which is discouraging private enterprise and investment. This is likely to lead the ECB to provide more liquidity to the banks over time, extending more funds to businesses and strengthening their balance sheets. We have seen some recovery in both European bond and equity markets, with bond yields falling back to more normal levels in peripheral regions and equities staging an impressive rally, registering a 24 per cent gain in 2013 on the MSCI Europe ex UK index.

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**Lee Robertson**

**CEO, INVESTMENT QUORUM**

**THE INDEPENDENT VIEW**

**Neil Williams**  
**CHIEF ECONOMIST, HERMES**

