CAZENOVE
CAPITAL MANAGEMENT

The outlook for European equities

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The market rally has taken the European equities a long way, and some of the cyclical exposure we bought last year is no longer in value territory, especially in the industrial cyclicals. Perhaps more significant is that fact that we are beginning to find growth beta relatively more attractive to cyclical beta. And within that we find a growing number of smaller and medium-sized businesses offering good growth at reasonably attractive valuations. Many large businesses still offer good value but show little sign of wishing to grow their invested capital by investing their surpluses. Indeed, large corporate surpluses in the large cap sector are the mirror image of the huge deficits being run by governments.

New Cycles

We are, however, finding parts of the European stock market where new cycles of investment are just beginning. They tend to be in rather esoteric industries, and are more likely to be found in Northern Europe, but there are signs of a pick-up in investment. The same cannot be said of much of Southern Europe, though even here there are businesses embarking on new investment cycles – look at Pirelli of Italy who are expanding their capacity in excess of 20% over the next 3 years.

A risk on the horizon

Last autumn we were of the view that European equities had got too cheap, and that global growth was not as bad as valuations indicated. We see little reason to change that view. There is one risk on the horizon and that is the French election. The Long Term Refinancing Operation (LTRO) has bought European politicians some time to look at a structural solution to the euro crisis. In the time bought by the ECB countries such as Italy and Spain are embarking on the fiscal and labour market reform effectively required by Germany. But there is still only funny central bank money on the table – Germany has not yet opened its balance sheet up to the mutualisation of sovereign risk in the Eurozone. We think they won't *just yet* for two reasons. First, to send a message to other miscreants, via the painful process that is the restructuring of Greek public debt, that German support is conditional upon reform. The second reason is that Angela Merkel does not yet know with whom she will be dealing with in Paris. Her clear public support of Sarkozy is, in our view, designed as a message to Francois Hollande, informing him that whoever takes residency of the Elysee Palace must play by German fiscal rules if they are to receive German largesse. Only when Berlin has a compliant Parisian neighbour will Germany allow the move towards fiscal union. This "gap" between the second LTRO and the French election in May offers the bears a chance to ask the question of France if it really wishes to remain in a Berlin-led single currency.

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