UNDERSTANDING THE RISKS IN EUROPEAN EQUITIES

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Political uncertainty, economic slowdown, declining earnings expectations – Stéphane Dutu, Fundamental Analyst, assesses the current risks faced by European equity investors.

Stéphane Dutu
Fundamental Analyst

Political risks are the first that come to mind when we think about risks for European equity investors. How would you describe the current situation?

We believe that European political risks have actually receded so far this year:

- Regarding Brexit, this is a very fluid situation, changing by the day.

  But, at the time of publication, we believe that the UK Parliament will either accept Mrs May's deal by 12th April – a less likely, but still possible scenario, or it will craft a softer deal over the next 12 months – a more likely outcome.

  Both deals could de-risk the Brexit saga and restore the confidence of both businesses and households which has been hurt by a Brexit process that has been too long and unnerving so far.

- In Italy, the rise of Lega at the expense of 5 Star in regional elections and in national polls has lowered the probabilities that 5 Star will be able to implement its most controversial spending plans, which could have destabilised Italian bond markets and ignited another euro crisis.

- In Spain, snap elections are likely to produce a right-wing coalition that will bring back mainstream economic policies.

Are there any other positive factors underpinning European equities?

Yes, the dovish policy shift of key central banks is another positive development for equity markets. Both the US Federal Reserve and the European Central Bank have recently signalled their intention to ease monetary policy should the global economic slowdown intensify.

As you say, the global economy is slowing – is this not a big risk?

Yes, the global GDP slowdown continues and it has to be said that the loss of economic momentum is most striking in Europe, especially in Germany. The country has been negatively impacted by a confidence crisis in its key automotive sector, as well as by its above-average exposure to decelerating international trade. And Germany, as the economic engine of Europe, is contaminating its neighbours.

Elsewhere, in China, the slackening pace of economic growth is not only the result of trade tensions with the US. There are also structural drivers that the communist leadership can only partially offset if it does not want to boost the financial leverage of China to a too dangerous level.

However, on a more positive note, the US has so far remained largely unscathed by the global economic slowdown. But, having said that, we are likely to see less robust US GDP growth over the next 12 months for the following reasons:

- The positive impact from the latest tax cuts will lapse this year.

- Political risks in Europe are actually waning and we should have increased visibility in the months ahead
- The global economic slowdown remains a concern and will impact corporate profits going forward
- We believe the defensive positioning that we have adopted in our European equity portfolios remains valid

- The lagged effect of past monetary tightening is starting to be felt in segments of the economy that are sensitive to interest rates, such as car sales and housing starts.
- The radicalisation of both the Democrats and the Republicans could dash hopes of a bi-partisan agreement on the necessary increase in public infrastructure spending. Should the Democrats seize Congress and the Presidency in 2020, they could even increase taxes, which would undermine the confidence of economic agents.

The US and China trade war continues to make headlines. What can we expect going forward?

The basic issues that have led to the trade conflict between the US and China have not been solved. The US administration expects a firm commitment from the Chinese authorities to deal with the following issues that they say hurt corporate America and US workers:

“The basic trade war issues between the US and China remain unsolved.”

- Lack of intellectual property protection
- Forced technology transfers
- State subsidies to corporate China
- The ever-rising trade deficit of the US with China

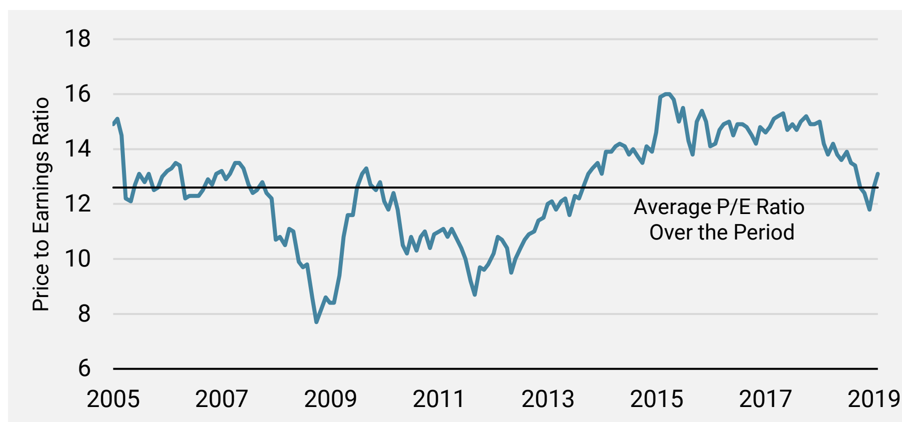
In addition, the US is also insisting on strict enforceability of any agreed trade deal, and is even considering maintaining the increased tariffs on Chinese imports until sufficient evidence has been gathered that the Chinese are keeping their word. We doubt the Chinese will easily accept these stringent requirements, so these trade war risks are likely to persist in the months ahead.

What’s the outlook for corporate profits?

As a result of the reduced pace of global growth, earnings expectations have been falling, which will be a headwind for equities. And with equity valuations already materially above their historical average, we expect that the current levels will not be sustainable in the face of declining profit forecasts.

“We expect equity valuations will not sustainable given declining earnings expectations.”

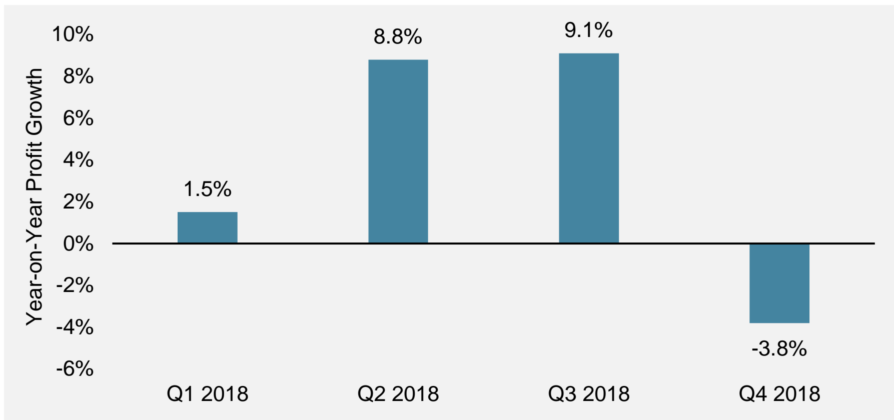
Figure 1: MSCI Europe – Price to Earnings Ratio 2005 to 2019



Source: Bloomberg, Unigestion. Data as at 28.02.2019

If we look at the numbers, earnings forecasts for the next 12 months are down 5% compared to their peak in September 2018. With a year-on-year earnings contraction of 4%, Q4 2018 was the worst earnings season in four years in terms of profits missing their expectations.

Figure 2: Year-on-Year Profit Growth for European Equities



Source: UBS. Data as at 28.02.2019.

Given the current backdrop, are you bullish or bearish?

So to sum things up, while European political risks may have decreased and central bank guidance may have become more supportive, there are potent negative forces that continue to weaken the case for equities. These include the unabated global economic slowdown, the unresolved trade conflict between China and the US, falling earnings estimates and equity valuations that are too generous.

Bearing this in mind, we think that the defensive positioning that we have adopted in our European equity portfolios since the middle of last year is still warranted.

"Despite a number of positives, the case for equities remains challenging."

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