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First, and most importantly, the European Central Bank (ECB) has demonstrated its willingness to act as a backstop, or safety net. Thus, ECB President Mario Draghi has provided leadership by:

- Launching the long-term refinancing operation, enabling the ECB to provide financing to eurozone banks
- Backstopping government bond markets when they have needed assistance
- Cutting rates to combat low inflation

These actions demonstrate that, when necessary, the eurozone’s institutions will take the measures required to maintain the single currency and support the member economies.

Second, leading indicators are recovering and we believe this will result in improved gross domestic product (GDP) and earnings growth in 2014. As Exhibit 1 demonstrates, business confidence has also revived.

Exhibit 1: Business confidence is on the rise

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is considerably less than in the U.K., which is experiencing a continuing annual fiscal drag of between 0.5% and 1.0%, and yet is enjoying a healthy recovery.

The improvement in Europe has been taking place at a time when emerging market growth expectations have been revised downward and a political impasse has affected the United States. We expect that the improvement in European growth prospects will account for the lion’s share of the change in global growth expectations for 2014 and 2015 (Exhibit 2).

Exhibit 2: Europe should become the main contributor to global growth
Contribution to change in global growth over the next two years, IMF forecasts

Sources: Deutsche Bank, IMF, September 2013

Falling equity risk premium

Another positive factor for European equities is that the equity risk premium (ERP) remains at a high level, but is falling. A high ERP reflects a relatively high return demanded by investors to balance the perceived risk of equity ownership. As tail risks recede and growth recovers, the ERP will fall and equity investors will become more confident about buying equities, thus driving up markets. Indeed, this phenomenon is already evident in the increased buying of European equities by U.S. investors, following a five-year absence.

European earnings have lagged the United States

It is worth noting that the European corporate sector has suffered from the weak macroeconomic background. European earnings remain 20% below their previous peak while U.S. earnings are now 14% above their precrisis highs. Much of this is down to margins, which have lagged significantly in Europe (Exhibit 3). In an improving European economic environment, we expect this gap to narrow.

Exhibit 3: European margins have lagged but may be poised to turn
Profit margins in the United States and Europe

Sources: Barclays Research, Datastream, November 2013

What does this mean for equity markets?

Traditionally, following a cyclical trough in Purchasing Managers’ Indices (PMIs), equity markets tend to re-rate ahead of a recovery in earnings. This factor lies behind the recent rise in the European market, which has experienced in excess of a 40% re-rating over the past 18 months, despite falling earnings. This type of reaction is far from unusual and Exhibit 4 shows that in the past, such a rerating has been followed by a period of flat price/earnings (P/E) ratios as earnings improve. We believe this is the situation we are now in and that the recent re-rating will be followed by an improvement in earnings.
Exhibit 4: Earnings recovery typically follows an equity market rerating

European forward P/E multiples and EPS from previous P/E troughs (1990, 2003 and 2008) — indexed to 100

Source: UBS European Equity Strategy, November 2013

We have recently upgraded our earnings expectations for Europe (excluding the U.K.) to 5% for 2013 and 10% for 2014. These are certainly not high earnings growth forecasts, but contrast starkly with recent downgrades and should present a more attractive environment for investors. Monetary easing in Europe, combined with rising earnings, should contrast positively with the impact of a tapering of quantitative easing in the United States, and the resultant pressure on emerging markets.

Where to invest?

So, where is earnings growth likely to be strongest? Domestic European sectors should lead the way and we have recently found strong equity stories in areas such as media and recruitment, which tend to be local or regional businesses. Exhibit 5 illustrates how earnings momentum in domestically oriented European stocks has increased in recent months.

Exhibit 5: Earnings momentum is expected to improve for stocks with domestic European exposure

Europe exposed estimates momentum — EPS and sales

Source: Redburn, November 2013

In addition, while financial sectors face numerous challenges, it is in the interest of European governments and regulators to ensure that banks continue to lend to the real economy. The ECB, in its role as banking supervisor, is conducting stress tests on the eurozone’s banks and the results will be known this year. It is notable that a number of banks (such as Unicredit, Banco Popular, Banco Sabadell, Bankia, Commerzbank and Deutsche Bank) have recently raised equity to bolster their balance sheets. The upcoming stress tests — considered by some analysts to be “a stealth recapitalization program” by the ECB — probably prompted this development. Consequently, we believe that the stress tests, rather than creating a new problem, will form part of the solution to the banking sector’s difficulties.
Valuations

Another factor in Europe’s favor is that markets remain attractively valued. Although we are some way off the lows of 2009, the cyclically adjusted P/E for Europe remains attractive in historical terms (Exhibit 6). With GDP improving and earnings expected to recover, the environment is attractive both from an asset allocation standpoint and in terms of stock picking.

Exhibit 6: European stocks remain attractive on a P/E basis

Conclusion

We have previously argued that we should not expect to see explosive growth in Europe or the eurozone, and this remains true. However, as long as the eurozone remains intact, Europe offers good potential to long-term investors. The ECB has shown its willingness to take the measures required to maintain the single currency and support the eurozone economy, while Europe’s politicians want to ensure that no further crises occur. As Aesop said, “Slow and steady wins the race,” and an environment with fewer shocks than has been the case recently should prove positive for European equity markets in 2014.
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