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Luke Stellini, European equity product director at Invesco Perpetual, provides his latest outlook for Europe Equities

The last eight weeks has seen a whirlwind of sovereign downgrades, collapsing economic data and stumbling politics across developed markets. Unsurprisingly, markets have suffered. We have gone from a consensus of muted recovery to one of possible double dip. Economic growth and corporate earnings have seen waves of downgrades too. The new reality has yet to be revealed. In this context, we look to extricate ourselves from the maelstrom and look for concrete measures, be they whole economy or stock and sector specific, that help us to establish our own views on the macro context and the best investment opportunities on offer.

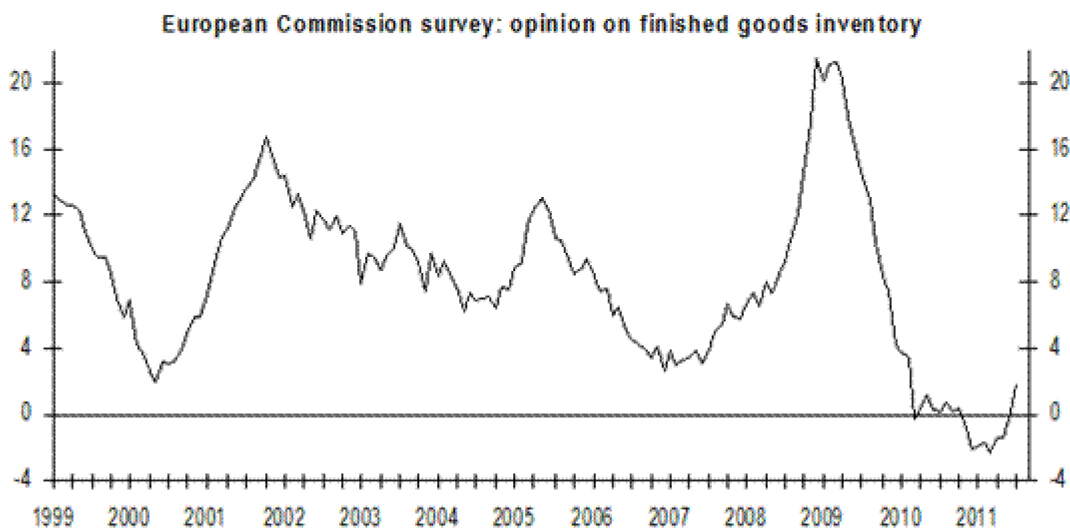
I do not propose to scavenge over the carcass of August's equity market. It would have been nigh on impossible to avoid the waves of fear and volatility that dominated every newspaper and television screen. Suffice to say that everything that could go wrong, did. Rather than go over it all again, I think it is more helpful to identify and discuss outstanding issues. Predominant amongst these is the debate about where we are heading. Investors and analysts have been grappling with the unknown in trying to ascertain the scale of growth downgrades that are required. At the more bearish end of expectations, Morgan Stanley now forecast global GDP growth of 3.9% in 2011 and 3.8% in 2012, down from 4.2% and 4.5% respectively at the start of the year. Interesting to note, that contained within these numbers are forecasts for developed markets (+1.5% developed market growth for 2011 and 2012) that do not involve recession. Other attempts have focussed on the need to benchmark against the 2008 experience. We think there are fundamental differences between the starting point now versus then, that make that comparative invalid.

Firstly, monetary conditions differ materially. Current, strongly negative real global interest rates (3 months - core CPI) at around -1.8% contrast with the far more restrictive backdrop markets faced heading into the '08 recession. Analysis of previous recessions by Credit Suisse suggests that the average real global interest rate stands at 1.7% at the onset of recession, again significantly more restrictive than now.

Negative Real Global Policy Rates %

Source: Credit Suisse as at 15th August 2011

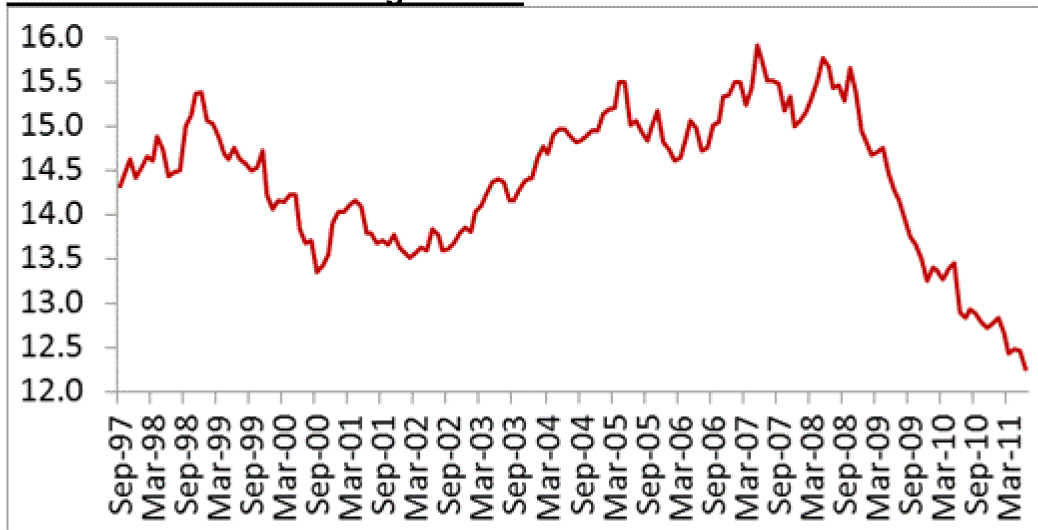
Secondly, markets also face a significantly more benign inventory picture than in 2008. At that time, companies were faced with a mountain of unsold stock in the face of collapsing demand. That situation led companies to shutdown operations overnight leading whole economies, like that of Germany, to print a negative 6.7% annualised GDP growth rate in Q1 2009. In contrast, inventory levels are at extremely low levels (growth expectations have been low for some time), implying that even in the worst case scenario of a contraction in growth, we do not face the same adjustments that we did three years ago. This in turn begs the question whether it is right to consider 2008 as the right benchmark.



Source: Credit Suisse 15th August 2011, Inventory index levels.

Lastly in contrast to 2008 the main engine of that crisis, namely leverage in the banking sector, stands at a vastly different level now. While there undoubtedly remain many banks in a variety of markets which are insufficiently capitalised for the new world of higher regulation, falling asset prices and lower loan growth, the sector has delevered materially. Since the beginning of 2007, European banks have raised almost €390bn of new capital (Source: Barclays Capital)

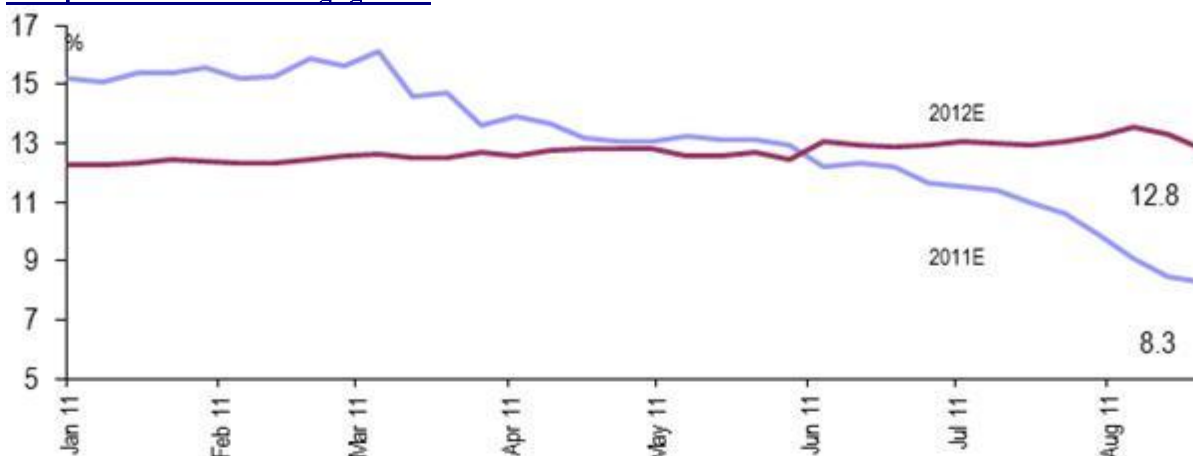
Euro Area Banks' Leverage Ratio*



Source: Nomura 22nd August 2011. *Total assets/capital & reserves

If 2008 fails to give us an appropriate steer, perhaps the scale and make up of the changes in earnings that we are seeing may help us to draw some valuable conclusions. Societe Generale point out that analysts only start to eat into their earnings forecasts after a couple of months of poor equity performance and therefore it is more likely that these moves will be lagging rather than leading indicators. To date, we have seen circa 5% off 2011 forecasts for Europe which leaves us expecting circa 8% growth for this year. Attention should shortly shift to the 2012 forecasts which currently stand at circa 13% growth. That estimate looks challenging and could be the focus of greater downgrades as we get to the time of year when next year's number comes under the microscope. With reference back to the bears at Morgan Stanley, they have slashed earnings forecasts for Europe, to growth of 5% in 2011 and a decline of 6% in 2012. Whether this proves to be an overly bearish, bullish or realistic number, the direction for the consensus looks lower.

European consensus earnings growth



Source: UBS 30th August 2011

Perhaps therefore, it is left to a bottom-up assessment to understand if expectations have been adjusted appropriately and whether valuations are credible. Three cyclical sectors,

materials, consumer discretionary and industrials top the table of earnings growth expectations (see table below). These sectors have led the market from its '09 lows to the early part of 2011, and while performance has suffered of late as the market has shifted from recovery plays to growth fears, they remain susceptible to material downgrades.

	Consensus EPS Growth (%)			
	2011	2012	2013	3Y CAGR
MSCI Europe	8.4	13.3	8.7	10.1
Sectors				
Materials	31.8	15.7	3.9	16.5
Consumer Discretionary	15.4	13.6	12.8	13.9
Industrials	10.3	14.6	12.2	12.4
Financials	3.4	23.6	12.1	12.3
Energy	20.5	13.1	4.1	11.7
Information Technology	-0.2	15.1	18.1	10.8
Consumer Staples	8.5	9.5	10.1	7.8
Health Care	2.5	3.2	5.3	3.7
Telecommunication Services	-2.8	5.8	5.4	2.7
Utilities	-15.5	9.7	3.7	0.4

Source: Morgan Stanley 22nd August 2011

To take the capital goods sub sector within industrials as an example, pre any further downgrades that the above growth forecasts may necessitate, work by BAML suggests that the PE and EV/Sales ratings on those forecasts are also materially too high relative to previous downturns. In other words, downside risks exist from both the forecasts for revenues and profits and the multiple applied to them. On the other hand, compound earnings growth of 3.7% for the healthcare sector and a PE rating of circa 10x look unchallenging. In our view, these distinctions between credible and in-credible forecasts, and challenging and unchallenging multiples are the best guide to extricating the opportunities from the maelstrom of today's European equity market.

These last examples and methodology provide us with the most solid basis from which to ascertain the merits of our investments. Do revenue and earnings forecasts look credible? Do multiples represent a possible floor? The answers to these questions lead us to our positioning. The top-down assumptions of growth and earnings are in a state of flux and are likely to remain so. There are some extremely important data releases and political decisions to be made over the coming weeks and months which will clarify the answers to questions about a second recession and the euro crisis. Our central case has not shifted from a view of anaemic growth in the context of multi-year deleveraging. In many cases that is more than reflected in share prices, in others it is not.

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Notes to Editors

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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