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Industry Views

Two-tier European market looks fit to survive impending recession

By Tim Stevenson, Director, European Specialist Equities

On his recent trip to Europe, Warren Buffett made the characteristically honest admission that he wished he'd been looking closer at European companies ten years ago. While the great sage explained that this trip was simply a window shopping exercise, his very presence indicates that he thinks there is some value to be found this side of the Atlantic. Having been finding good opportunities within Europe for the last 17 years, we could have told him that and saved him the fuel.

With consumer goods, financials and automobiles overburdened by the spectre of impending recession – and consumers hastily tightening their belts, what now for Europe? What we are seeing now is a two tier market, where the positive performance of some sectors has a direct correlation with the underperformance of others.

The recent results season highlighted strength in emerging markets and pricing power, and negative headwinds coming from rising input costs and currency impacts (mostly transactional). It was also interesting to note that during the first quarter, companies in the US were more cautious than their European counterparts, and American consumers seems to be under greater pressure than those in Europe.

Recent survey data from Germany suggested that business confidence is still strong, although export numbers started to decline in March. You have to question whether a country so heavily based on exporting capital goods and automobiles will be able to continue to take the belt tightening and oil price rises in its stride. More importantly, a rising Euro always has a significant impact on exporting countries, and in the past year the Euro has gained 15% against the dollar. German confidence indicators are well known for their underlying sense of sang froid, but it will be worth monitoring whether this composure remains if the headwinds persist.

There are some bright spots. Along with the oil related stocks, engineering companies have also been performing well. Investment to improve the efficiency (in every respect – such as energy use as well as processes) of manufacturing as well as in power generation and transmission has continued. Mining has also been strong and although the enthusiasm for these areas can wane for a month or two after such good performance, the underlying thesis for these sectors is as strong as ever.

However, the over indebtedness of countries such as Spain, Ireland and the UK will continue to be a concern, and the economic news is expected to remain worrying for a few more months. Investors with a rational and long-term perspective simply have to ride through these lean times, while picking up the occasional opportunity when markets punish a company's share price too aggressively. It is always folly to try to judge companies on a quarter by quarter basis, and sometimes it pays to step back from events and keep an eye on the fundamentals of a company in order to take a healthier perspective overall.

Tim Stevenson is fund manager of the Horizon Pan European Equity Fund

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