

Will European equities continue to outperform?

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For equity investors, Europe has been the place to be in 2006. During the first three quarters of the year European equity markets, as measured by the Morgan Stanley index, rose by 17% in US dollar terms. This compares to gains of 10% in Asia-Pacific and emerging markets, 7% in North America and zero in Japan. And this is not a flash-in-the-pan. Looking back over the last three years, European markets were up 77% in US dollar terms. True, emerging markets did better, producing a rise of 106% (though they gave you a bumpier ride), but Asia-Pacific (71%), Japan (54%) and North America (37%) all lagged behind.

The outperformance of European equity markets cannot be attributed to the economic dynamism of the region. The global economy has grown strongly in recent years – on some measures at its fastest rate since the early 1970s – but Europe has not been a major beneficiary. According to the recently published IMF World Economic Outlook real GDP in the European Union will increase by 2¾% in 2006, lifting the average growth rate for the last three years to a modest 2¼% - in line with estimates of trend growth for the region. Over the same three years the US economy is forecast to have had average growth of 3½%, Japan 2½% and emerging market and developing countries 7½%.

The European Union now comprises 25 economies, and it is wrong to generalise too much. Some countries (Ireland and Spain for example) have grown strongly in recent years, but Europe's growth appears to have been held back by slow growth in consumer spending in its larger economies, and in Italy and Germany in particular. Again according to the IMF, consumer spending growth in Italy over the last three years has been just ½% a year, while in Germany it was an even more disappointing ¼% a year.

Italy's problem appears to be one of failing to adapt to the changing global economy. Its industries continue to lose share in global markets despite support from the European Union – most recently in applying tariffs to imports of shoes into the EU from China and Vietnam after pressure from Italian manufacturers. As a result employment growth is sluggish, holding back spending power, and households are reluctant to reduce their saving or to increase borrowing to fund spending because of fears about the future health of the economy.

Germany is the more interesting case. Here it has been the actions of companies that have caused consumer spending to be weak. In the face of increasing competition from Asia and the strength of the euro against the US dollar and Asian currencies, German companies have been aggressively restructuring and cutting costs. They have been helped in this task by the expansion of the European Union eastwards to take in such former Soviet bloc countries as the Czech Republic and Poland. In some cases, production has been transferred to these countries, where costs are cheaper. In others, simply the threat of shifting production has been enough to make workers accept wage freezes, longer working hours and other cuts that save companies money.

These measures have been successful, in that they have enabled German companies to increase their share in global markets despite the strength of the euro. Indeed, Germany is now the world's largest goods exporter. It also goes a long way to explaining the performance of European equity markets in recent years. Cutting costs has enabled companies to limit price rises so as to remain competitive, but it has also allowed them to boost profit margins. They have, thus, been able to translate modest economic growth into strong profit growth.

There is every reason to believe that investors can continue to benefit from this trend in coming years. Although many of the easy gains have probably been made in Germany, companies in other Western European economies are likely to follow their example. The accession of Bulgaria and Romania to the European Union in January 2007 may also provide a fillip to the process.

Of course, this does not make European equity markets immune to more general risks to financial markets. If the plummeting US housing markets ultimately leads to a sharp drop in US consumer spending and a global recession, Europe's economy will weaken and its equity market will likely drop along with others. Alternatively, a renewed surge in inflation and higher interest rates would also be damaging to equity markets. But these should be seen as risk scenarios. If the global economy continues to expand at a reasonably healthy pace and central banks keep inflation under control, there should be scope for equity markets to make progress from present levels. If so, the ability of European companies to extract strong growth in profits from moderate economic growth should ensure that the region's equity markets continue to produce good returns.

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