

Will European equities catch a cold?

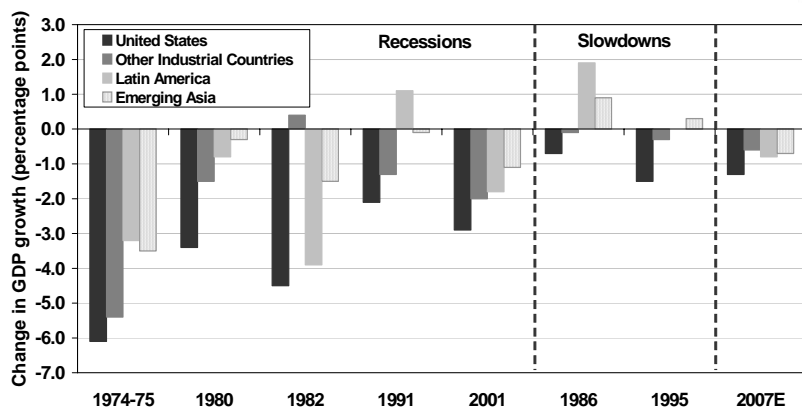
By Raj Shant, Director of Investment Management (European Equities) at Newton

"If America sneezes the world catches a cold."

After the outbreak of the subprime crisis and all the contagion and concern that has gone with it, financial markets' focus has moved to the next key point: will the financial crisis lead to an economic crisis? Let's assume that falling real estate prices and the credit turmoil do slow the US consumer. The question a European fund manager then has to ask himself is the Dirty Harry trademark "Do you feel lucky?"

Pretty lucky, as it happens

If we start with the assumption that the subprime issues only impact the subprime constituency (i.e. the poorest consumers) then numerically the impact on total consumption would be modest. Citigroup recently pointed out that the top 20% of income earners spend more than the bottom 60% combined!¹ The impact on economic growth would be muted. The chart below, drawn from an IMF study, shows that when US growth has slowed by less than two percentage points the impact on the rest of the world has been modest. In this scenario Europe could come through relatively unscathed.



Source: IMF, Morgan Stanley

Ah! But what if it's worse?

Clearly there is a risk to the downside. Falling real estate prices and a credit crunch could lead to a collapse in confidence and consumption, resulting in an outright recession. The IMF study cited above would suggest a far worse outcome for Europe (and thus European equities).

But now is not then!

Assuming that historical relationships merely repeat themselves is a lazy man's fund management. The world has changed. Emerging countries have grown so rapidly over the past decade that they now account for over 30% of world GDP and even more of world growth.

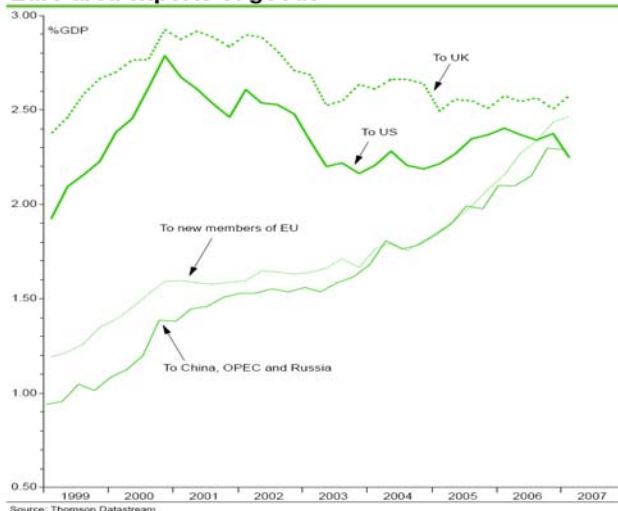
Trading patterns have changed!

Europe's exports to the booming economies of OPEC, Russia and China have now eclipsed exports to the US.

These countries have trillions of dollars in reserves and are clearly in a position to continue to implement infrastructure and development plans even in the face of a more serious slowdown in world growth.

Exports to the new members of the EU look set to become more important than even the UK. And we haven't even mentioned India or Brazil!

Euro area exports of goods



Source: Thomson Datastream, DKIB

Why is Europe benefiting disproportionately?

As the US and UK spent much of the '80s and '90s de-industrialising, Continental Europe retained much of its industrial prowess. Now, as the developing economies industrialise rapidly, they are turning to European companies to supply everything from power generators to factory machines.

Not a cloud in the sky?

September promises to be a tricky month for markets. This week the European Central Bank meets, and an increase in interest rates would clearly be negative for the economy and the markets. Similarly, the Federal Reserve meeting on 18th September would disappoint if it brought no rate cut at all. Finally, September brings a fresh crop of earnings reports from the big US investment banks, with plenty of scope for nasty surprises.

So what are we doing?

We have reduced positions in cyclical stocks with substantial US exposure. However, we continue to like companies with substantial exposure to developing countries' infrastructure needs. Overall, we recognise the risks but we see value emerging in many large-cap parts of the market. While it is never a bad idea to keep a handkerchief ready, it would be wrong to assume that a couple of sneezes constitute a cold.

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¹ Source: Citigroup, August 27, 2007

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