



Europe - PIGS Might Fly

We assess the contrarian view against a background of unremitting gloom.

Europe's initial rescue plan for Ireland gave rise to a brief relief rally for stocks and the Euro but was short lived as the familiar fears of contagion to the other beleaguered Euro zone countries of Portugal, Spain and Italy were stoked by continued negative sentiment in the media and conflicting messages from European politicians and policymakers.

The assurances from Euro zone finance ministers attempting to shore up confidence with comments such as "Portugal is different from Ireland", "Spain is different from Portugal" and so on, are being swept aside by a market seemingly unwilling to distinguish between the constituent members. It seems that if a nation is part of the PIIGS acronym, it must be in trouble to the point of many managers choosing simply to have zero exposure to these nations bonds and equities.

However, should we not attempt to apply a common sense risk premium to exposure, not just in the Euro zone as a whole, but to the PIIGS themselves? After all, the Euro zone is home to some of the best

quoted companies in the world yet have suffered from a general de-rating since before the Greek crisis finally unfolded in May this year. Indeed there is a palpable sense of déjà vu from the Spring when stocks, and banks in particular, were heavily sold off and a general flight to safety led to a weakening of the Euro. We have not yet seen a return to the lows against Sterling seen in late June but, at around GBP/EUR 1.18, we are not far from those levels of maximum fear from which there came a significant rebound. Could this be an indication that, in reality, the market sentiment towards the Euro is not as bad this time around?

From a forward PE valuation standpoint, we see that Euro zone equities have already been sold down to levels not seen since the early 1990's. This is perhaps not surprising in the middle of a market racked with a sense of crisis but will have to count for something in the longer term. We would have to see a downgrade to earnings of something of the order of 15% just to see a rerating back to the long term average of around 13.7x. We find this unlikely given that the biggest downgrades affecting the overall market have been in financial stocks and there is a sense that there has been some recovery and sentiment here is improving. Equity markets historically attempt to anticipate conditions nine months out. Whilst we recognise that the current mood concerning the peripheral Euro nations is in a critical phase, we also believe that there is a compelling case for European equities overall. Reflecting the negative sentiment, pan-equity dividend yields are now higher than Bund yields and forward PE ratios appear historically cheap. Bank lending across the region, while low, is in positive year-on-year territory. We also note that economic indicators, such as industrial surveys, inventory data or analyst earning revisions are recovering from lows. Even M&A activity appears set to recover from its nadir.

We closely follow the drama unfolding daily and remain conscious of the effect it has across the world in all asset classes. However, we must remain alert to the possibility that a positive re-rating of Euro zone equities will take place if the unremittingly bad news starts to fade as resolution replaces crisis. Within such a scenario, an opportunity may arise for a very positive bounce for the indices of the peripheral Euro zone nations and PIGGS might fly.

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