Weekly Digest

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A Song For Europe

One (possibly unmourned) victim of Covid-19 was the Eurovision Song Contest. When I first watched it in the 1960s (yes, in black and white), the UK was a regular winner. We can but pine for the days of Sandie Shaw and Lulu, with nothing to celebrate since 1997! European equities have been through a similarly barren patch since the global financial crisis, but, unlike our europop industry, might finally be ready to make a comeback. We haven't been overweight Europe (ex-UK) equities for a while, so why consider it now, and in preference to the UK?

First, we think that Europe is "having a better crisis" than the UK, after a sticky start, admittedly. Infection growth appears to be more controlled, and major countries, such as Germany and France, were not in danger of being overwhelmed on the healthcare front. More pertinently, European governments and institutions, such as the European Commission and the ECB, have stepped up with support in a way that might not previously have been expected, and was certainly not forthcoming in the financial crisis. Germany, notably, has thrown off the shackles of austerity, providing a lead for other countries. The ECB's policy decisions have substantially reduced the risk of accidents in the banking sector, with peripheral sovereign bond spreads having tightened considerably. Germany's constitutional court appears ready to remove its objections to the ECB's asset purchase policy. Thus Europe is well positioned to take advantage of the global post-Covid recovery, short-term concerns about recent new outbreaks notwithstanding.

Politics also comes into play. Europe's electoral calendar is relatively quiet at the moment, with Italy probably the next major country to go to the polls in 2021. We might have been more worried about Italy a few months ago, but the government looks more stable, and promises of fiscal support will help too. Meanwhile, as Brexit continues to play out, the risks for the UK look larger than those for Europe in terms of the "no deal' scenario that remains a distinct possibility. Recent references to sterling as a new "emerging market currency" are of concern. Philip Shaw, Investec Bank's chief economist, last week lowered his near-term outlook for the pound based on economic and political risk. The euro could also benefit from increased uncertainty around the US election, which is now just four months away. Both the euro and European equities are considered to be "under-owned" in global portfolios.

One interesting development I spotted last week came in comments from the European Competition Commissioner, Margrethe Vestager. Having spent most of her first term in the role standing in the way of consolidation, in her second she now seems to be championing mergers to create pan-European regional champions, notably in the telecoms sector. That's quite a change of heart. She has also spoken of the vulnerability of European companies to opportunistic buyers from the US and China, and would like to see them remain under local control.

From a portfolio construction perspective, and more related to moving further funds out of the UK, our Asset Allocation Committee's view is that the overall weighting in UK equities remains too high relative to the opportunities available in global markets. The fortunes of the UK market are, as we have seen this year, narrowly focused, with a high emphasis on Resources and Banks, neither of which industries have had a good year. Nor do we see grounds for an imminent strong outperformance, given the prospects for interest rates (lower for longer) and the increasing emphasis on ESG and climate change. The UK remains a desert in terms of large cap Technology and has few world-beating large industrial companies. In a recent FT survey of the top global gainers by market capitalisation during the Covid period, one had to get down to 92nd on the list to find the first UK company – AstraZeneca. A recent note from Goldman Sachs highlighting a long-term preference for the sort of high return-on-capital companies that we tend to back ended with a list of 50 "World Winners" which contained not a single UK-listed company.

I will admit that we have highlighted in the past that Europe's Tech weighting is still only 6% versus about 1% in the UK and 25% in the US, but that's still one-and-a half times the exposure to Oil (4%). Healthcare in Europe (an industry that we recognize as a secular grower) accounts for 17%, versus 7% in Banks. Before the financial crisis, Banks were the largest sector. The STOXX Europe indices' composition looks more favourable now than at the start of its decade-long demise. Europe also scores highly on ESG (Environmental, Social and Governance) measures, and should benefit as more funds back those themes.

Whereas recent portfolio shifts have been towards the US, now does not feel like the optimal time to be pushing further in that direction. The toxic mix of Covid and politics suggests a trickier period ahead for the US. The possibility of a Democrat election win is very real, and that could mean harsher regulation for Big Tech and a reversal of Donald Trump's corporate tax cuts, which could reduce S&P 500 earnings by around 10%. The rerating that US Growth has recently enjoyed has been to a great degree the result of the acceleration of existing social and technology trends boosted by a lower discount rate. It is hard to imagine the same set of cards being played again in the short term. Meanwhile, Europe tends to be more positively correlated with economic recovery and gives us a bit more exposure within an overall equity position that remains relatively Growth/Defensive given our stock selection process. Whisper it quietly, but it is possible that Europe's GDP growth rate in 2020 and 2021 will surpass that of the US - admittedly because it has further to bounce following the Covid-related recession, but the optics are positive.

Finally, it is clear that the large yield advantage enjoyed by the UK has now been lost, with little prospect of it being recovered. Our current internal probability-weighted projection for UK dividends in 2020 suggests a 58% reduction in distributions relative to 2019. There will be a bounce in 2021, but some dividends are gone for the duration, and others will be re-set at lower, more sustainable levels. I will return to the subject of income in the coming weeks, with a look at alternative sources.

Last week's Economic Highlights

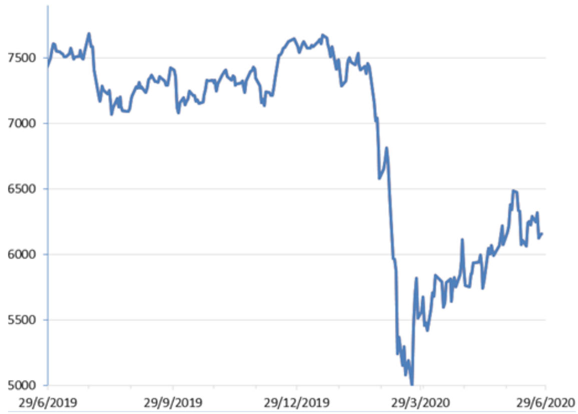
FTSE 100 Weekly Winners

Just eat Takeaway	7.8%
Fresnillo	5.7%
Avast	4.8%
Ocado Group	4.0%
Sainsbury	3.6%
Kingfisher	2.8%
Intermediate Capital	2.7%

FTSE 100 Weekly Losers

IAG	-18.3%
Rolls-Royce	-14.7%
Hikma Pharm	-10.1%
IHG	-9.2%
Land Securities	-8.5%
Next	-8.4%
ITV	-8.4%

FTSE 100 Index, Past 12 Months



Source:FactSet

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