



EQUITIES Europe



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Challenging the consensus



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The consensus outlook on the European economy remains negative, but that consensus is likely to be challenged in the months ahead. Europe's exposure to global growth, which has allowed it to take advantage of improving demand in faster growing parts of the world, should stand it in good stead as those economies continue to recover.

The significance of European exporters' exposure to emerging market demand is often overlooked. Germany, with the equivalent of about US\$1.5 trillion of exports per annum, is a particular beneficiary of that demand and is the world's second largest exporter (having been overtaken by China during the first half of 2009).

European monetary policy should also be supportive of the region's economic wellbeing. The consensus has been that sluggish policy responses have condemned Europe to lagging the recovery seen in the other major economic regions. However, that underestimates the protracted and concerted efforts of European monetary policymakers to ease economic and financial market strains since the beginning of the crisis in credit markets.

The European Central Bank (ECB) made vast injections of funds into financial markets in June and September in the form of one-year 'repos' that allow banks to deposit a very wide range of assets with

the central bank for a year in return for cash at a borrowing rate of just 1%. Such operations should continue to support economic activity in the coming months.

Looking after its own

Pessimists often point to Europe's sluggish consumption, but consumption has never been as important to economic growth in Europe as in, for example, the US and the UK. There are even reasons to be positive about the outlook for European consumers. In particular, the threat that rising unemployment will hamper consumer activity is tempered in Europe by the generous welfare arrangements which soften the transition from employment to unemployment, and thus dampen the fear of unemployment. Such arrangements partly explain why consumer confidence and consumer spending in Europe have been relatively resilient during the credit crisis. Furthermore, European households did not come into the crisis saddled by the high levels of debt that threaten to stifle the activities of their US and UK counterparts.

Eastern Europe also seems less likely to implode than it did in the early part of 2009. Strong policy action from the EU, the ECB and the International Monetary Fund, and the passing of the immediate crisis, has bought the most beleaguered countries enough liquidity and time to work through their problems. 2010 will still be a difficult year for the eastern European countries, but growth should resume from 2011 onwards.

Tensions loom

As things improve during 2010, there is a risk that tensions will start to escalate over the longer term, both within Europe and between Europe and other regions.

One area of conflict could be the euro; while a strong euro may be interpreted as a sign of Europe's economic strength (and may be effective in raising general living standards), a highly valued currency is a thorn in the side of exporters. With Asian countries trying to hold down the value of their currencies to maintain their competitiveness, the euro has acted as a 'safety valve' in foreign exchange markets, appreciating against most major currencies. But excessive euro strength is bound to result in increased international tensions, eventually.

Furthermore, a German recovery may put pressure on the ECB to raise rates in the second half of 2010, a move that would

be unpopular with countries like Ireland, Spain and Greece (for whom higher interest rates would threaten already fragile domestic activity).

Like a family in a crisis, European nations are likely to be united as long as economic and financial market conditions remain challenging but, as those conditions ease, such unity may weaken; Germany's patience with Ireland, Spain and Greece, for example, may wear thin if it feels that they are dragging their feet tackling structural problems. Equity investors will need to take account of such risks and, in bond markets, investors should be mindful that yield differentials between government issuers may widen quickly if tensions build.

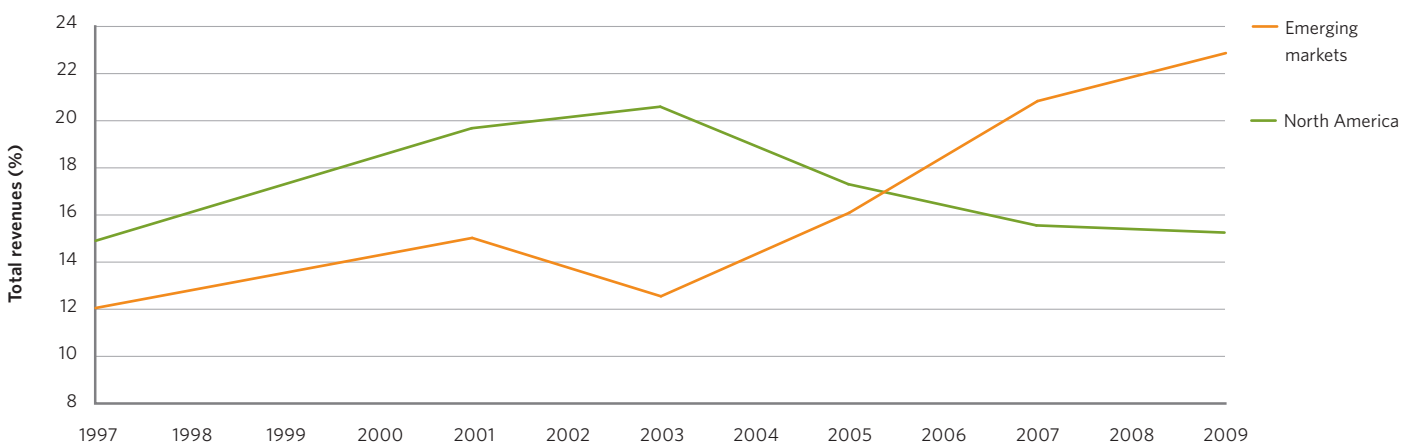
Balancing act

The policy response in Europe has been unprecedented in scale, export activity should continue to improve, and European consumers should prove to be more robust

than widely expected. With Europe's monetary policymakers explicit about their intention to maintain 'loose' policy for the time being, and with interest rates offering little solace to yield hungry investors, share prices may well strengthen further during 2010 (albeit that mounting tensions later in the year may mean that gains occur predominantly in the first half of the year). The dividend yield on European equities also looks very attractive compared with government bond yields (and certainly with short-term cash rates as well).

Over the longer term, challenges in the aftermath of the global credit crisis are likely to affect corporate prospects for some time in Europe (and elsewhere), but the region's globally diversified, 'blue chip' companies should be well placed to benefit nonetheless from economic improvement in the faster growing areas of the world.

EUROPEAN EXPORTERS' SALES TO EMERGING MARKETS NOW EXCEED THOSE TO THE US



Source: Morgan Stanley, September 2009

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