



# Rays of light amid the gloom

## A thematic view of Europe's economy suggests significant opportunities for investors with a long view

**T**he headlines on the European economy this year have oscillated between the gloomy and the downright apocalyptic. Between Greece's threatened sovereign default, the parlous state of public finances across much of Europe, and stagnant Eurozone growth, investors have been understandably reluctant to dip their toes in European equities.

Though the German industrial powerhouse has started to show signs of its old vim, the overall picture is one of fragility rather than rude health. The IMF is only forecasting 1 percent GDP growth in the Eurozone this year, increasing to a flaccid 1.3 per cent in 2011.

Why, then, would an asset manager advise clients to look afresh at taking equity positions in a continent where growth is anemic in comparison to the aggressive Asian economies?

Part of the answer, says Rajesh Shant, head of European Equities at Newton Investment Management, is that the picture in Europe is not as uniform as is often painted.

Europe has had its casualties over the past three years, from Northern Rock to Greece's state finances, but to tar the entire continent with the same brush is a fatal misreading of the European economic barometer.

"In Europe we'd say that actually there are big chunks which just don't have these

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### There are big chunks of Europe which just don't have these problems

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problems. If you look at Germany, for example though they have a modest austerity programme, the economy is growing very strongly and their deficit is far less than the UK, US, Spain or Ireland and they started with lower debt to GDP ratio anyway," says Shant.

Add into that equation the Netherlands, a well-run economy with strong finances and Austria and Switzerland, which have no issue at all in terms of these problems, and it's clear that Europe is not quite the debt-laden laggard of easy caricature. Even more striking are the Scandinavian economies – some of the soundest and richest in the world.

Newton's approach is to take a broader perspective on Europe. "We have a very global perspective which is a differentiating feature. Because we look at Europe in the whole we don't assume that the world begins and ends at the borders of Europe," says Shant

This is important, as it is Europe's relationships with other parts of the world that will help determine its ability to stage a recovery from the post-Lehman troughs.

"The key markets for many of Europe's multinationals are outside of Europe and many of the key competitors are outside

of Europe. So we really believe that global perspective matters a great deal," says Shant.

This perspective sits alongside Newton's thematic investment philosophy that seeks to identify key global themes and then build up a portfolio positioned to reflect those themes.

"These themes are our interpretations of longer term changes going on the world. The combination of that global perspective and the use of themes helps us to try to focus on those parts of the market where we believe are the best prospects for longer-term growth," says Shant.

When it comes to the investment strategies to outperform in a context of sub-par Eurozone growth, this thematic approach means tracking longer-term growth cycles.

"We're believers in a theme called All Change. The idea behind this is that the credit crisis wasn't an event, it was the beginning of a process. In fact, levels of indebtedness across the western world had risen for many years going back to the falling interest rates of the 1980s. So cycle after cycle would just achieve ever-higher levels of debt-to-GDP. All Change therefore implies we have begun a long process of unwinding that leverage."

Deleveraging, says Shant, will be the defining force shaping the European economy for years to come.

"Governments are now left with a huge and rapidly increasing pile of debt that

has more than offset household deleveraging. So we haven't really in earnest begun the process of deleveraging which we think will play out over many years," says Shant.

The challenge for governments is to manage the deleveraging process without excessively dampening economic growth. "It shouldn't happen too quickly, otherwise economic consequences would be dire, yet it shouldn't happen too slowly or else you end up with lost decades like Japan," says Shant.

While German and Italian households have generally saved more of their incomes than the equivalent US or UK, the level of deficits in the Eurozone has picked up sharply in the wake of the credit crunch. "Before the crisis, deficits used to run at about 2 percent [debt-to-GDP] and now the average is over 6 percent," says Shant. "Austerity programmes are just announcements at the moment. It is possible to experience fiscal austerity and a degree of deleveraging by the private sector without a recession, but you do have to get speed of deleveraging just right to pull that off."

For investors eyeing European exposure, deleveraging will have a significant impact as the entire western financial system is facing constrained credit growth. For banks, this means a tough environment where the old rates of return on equity will seem like a distant memory. "Their balance sheets can't grow in quite same way as they did and they can't exploit rising asset prices in the way many did. On top of that, regulators are requiring them to hold a lot more capital to protect the financial system against future shocks," says Shant.

This is a negative for the overall financial system and will pressure those markets that face the structural headwinds of high levels of debt with cuts in spending. "We are cautious on those parts of the consumer sector that are most exposed to the western world but we think that those with greater exposure to emerging markets, especially Asia, will prosper in both absolute and relative terms," says Shant.

This underlines the stress on careful management of risk, which forms a critical component of the Newton approach, says Shant.

"We spend as much time on the risk as on the upside which really came though in the toughest period of the credit crunch. Our aim is to generate better returns than our peers over the long-term, but do it with lower levels of risk. And that centrality of considering the risk profile in our investment decision making does make a difference as quite often the debate tends



Rajesh Shant

### Focus on stock ideas that show reliable growth

to focus solely on the upside – how much would money we make on this rather than how much would we might lose when things get tough," says Shant

Give that context, Newton focuses on the stock ideas that show reliable earnings progression without being cyclical and over dependent on leverage.

One core theme is the 'networked world', the idea behind which is that there is substantial growth in the power of networks. Greater use of Blackberries and iPads is one key driver of this process.

"The power of these networks is growing dramatically, even in countries that don't have a fixed-line network. We think there are opportunities in this growth that may be being neglected, and the ones where valuations least reflect those opportunities are in telecoms companies," says Shant.

European telcos have been in the doghouse since the 2000 bubble, with fixed-line call rates driven down dramatically and regulators forcing them to open up to competition. But a whole new area of growth is opening up in non-voice traffic.

"Every time we exchange emails over Blackberries, that means more and more traffic going over a fixed-cost network, so we are beginning to see that after years of revenue pressures, several stocks in sector are showing signs of top-line growth returning," says Shant.

"If you get rising top line with a lower cost base, the improvement in profitability for the sector could be quite meaningful – and in the meantime you do get some quite attractive dividend yields while you wait for earnings growth to kick off."

The other standout theme is Medical Technology, which again links back to Newton's thematic framework. The western world population is getting older and each decade of life amounts to more healthcare products and services consumed. "Likewise, in emerging markets, once basic needs of food and shelter are met the next most basic one is healthcare. So demand for overall medical services will be increasing very sharply for many years to come," says Shant.

Innovation is the key. "The reward for a product or service that is really going to help save money is going to be much greater than in previous years, so one area we are quite interested in is diagnostics. Better diagnostics means more targeted treatment and could save individuals and healthcare systems in emerging markets a lot of money. That's an area where we expect great long-term growth" says Shant.

According to Shant, telecoms and medical technology are areas where investors can make absolute and relative returns for years to come if they take a long-term perspective against the backdrop of sub-par growth coming in.

Key stocks here are the German diagnostics group Qiagen, while in telecoms, one of Newton's biggest holdings is Deutsche Telekom.

Alongside the sectoral strategies, Shant argues that the investment style is equally important. Over the long run, it is the growing dividend stream that the investor receives is the crucial differentiator for equities over other asset classes.

"At times of modest growth, if you have got even slight growth in dividend income streams, you are still compounding at an attractive rate and for a long-term investor even if the market goes down your incomes stream never actually goes negative so you can afford to look through those fluctuations in the market."

Newton has developed equity income products in European equity – such as its European Higher Income fund – that factors in the income stream and likely growth of the dividend into all investment decision making.

Deleveraging and sub-par growth will doubtless inform the narrative for European economies for years to come. From Newton's thematic standpoint, this still affords some strong opportunities for investors willing and able to take the long view. ■