DNCA INVESTMENTS

Market review

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"Focus investments on the eurozone"

Macroeconomic and financial markets outlook, DNCA's eurozone analysis

Following the August sell-off, markets have continued to slide. Investors still fear a marked slowdown in the global economy, triggered by a sharp decline in emerging markets, led by China. Furthermore, the Federal Reserve's decision to delay raising its base rates was another cause for concern, although it now appears that an initial hike is likely before the end of the year. In Europe, the automobile sector was hit particularly hard following the revelation that Volkswagen had manipulated data regarding diesel engine emissions. After the euphoria during the spring, most European indices are now down on the year. The eurozone remains the only major region however in which economic growth outlook is improving in 2015. For the time being, European companies are not downgrading their forecasts, with the exception of certain specific sectors (oil).

We consider 2015 eurozone GDP growth estimates of 1.5% to be achievable. Growth could be closer to 2% in 2016. Only a few months ago, many observers doubted that European growth would be restored. Europe is growing while global economic forecasts are being revised downwards, chiefly due to a slowdown among emerging markets, particularly China, Brazil and Russia. As for the US, economic growth will probably be capped at around 2.5%.

Favourable economic momentum

How is this possible? There are three main reasons.

Firstly, the ECB is likely to maintain its ultra-expansionist policy until at least the end of 2016, unlike the Fed which will have to tighten its monetary policy, while its comments are becoming increasingly ambiguous.

Secondly, the depreciation of the euro:
To its great merit, the ECB has managed to weaken the single currency, to the major benefit of the region which is largely a net exporter.

Thirdly, commodity prices have fallen. The eurozone, which is only a minor producer, is one of the main beneficiaries of the drop in the price of oil and basic resources in general. The improved economic climate is discernible in the PMI indices which are now at four-year highs. Furthermore, the economic recovery appears to be of a lasting nature, as the level of borrowing has also increased. Productive investment is the only real concern, as its recovery appears sluggish. Global industrial overcapacity remains high and companies are likely to allocate their financing capacity towards external growth,

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rather than capex investments. Furthermore, the high premiums offered in recent takeover bids or potential deals, such as XPO Logistics on Norbert Dentressangle, Fnac on Darty or Heidelberg on Italcementi, reflect the buoyancy of the mergers & acquisitions market.

Over the past few months, improved fundamentals in the eurozone have been overshadowed by the Greek situation. The provisional solution will enable investors to become more aware of European economic potential however.

A pleasant surprise for company earnings

All of these factors bode well for corporate earnings. For the first time in five years, earnings generally beat forecasts. The challenge for European companies will now be to progressively reduce their profitability gap with their US peers. In 2014, return on shareholders' equity was 9% among Euro STOXX companies, compared to 16% for the S&P 500. Any further market rally will depend on strong earnings growth in Europe, while profits are expected to shrink on the other side of the Atlantic.

Equities remain the preferred asset class

The improvement in fundamentals was certainly eclipsed by the Greek situation in the spring and the slowdown in the Chinese economy this summer, causing a high level of turbulence among markets. The Volkswagen scandal has provided a fresh source of volatility in an important sector for the European recovery. The chaotic media coverage of this topic at the moment makes it difficult to analyse its impact on consumer confidence and the automobile sector in general. For the time being, morale and confidence among business leaders seems to be steady, as illustrated by the latest Italian and French indicators.
Despite the sometimes legitimate sources of fear for investors, European equities certainly remain, in relative terms, one of the best global asset classes, with the sell-off over the past few weeks providing a long-term investment opportunity. We are therefore maintaining our conviction: increase eurozone equity weightings by focussing investments on predominantly domestic players.

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About DNCA:
DNCA is an investment management company founded in 2000 by specialists who are experts in pursuing a value-based focus to managing wealth for private and institutional investors. Adopting a defensive bias, the company seeks to optimise the risk-return profile of its portfolios. Through its team of over 86 employees, DNCA has developed expertise in European and international equities (long only and absolute return), diversified management, convertible bonds and euro-zone bonds.

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