The sun finally shines on the periphery

Smaller-caps are boosted by the recovery in Europe
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Introduction

2014, an inflection point
We have called 2014 the year of “show me the money” – we expect the turnaround in growth, which has picked up in the US and Europe over the past two years, to flow through equities earnings growth. The support that central banks are providing to the markets in developed economies, together with better economic fundamentals in the US, Europe and Japan, are the main factors that have led to a tightening in sovereign yields across the non-Emerging Markets universe. Inflation is low globally, a direct effect of the current output gap, which is a legacy of the recent financial crisis. The capacity slack shows that the global economy is at a point in the business cycle where it should be able to absorb further spare capacity before rates are raised across developed markets.

In this edition of Perspectives, we look at what we believe is the best way to take advantage of the recovery in the European periphery, and specifically the implications for Spain and Italy, given the increasingly brighter domestic economic data in Europe. Smaller and mid-sized companies (SMIDs) in Spain and Italy are favorably positioned to benefit from the ongoing, gradual recovery, and we set out why we expect them to perform well in the current environment. We will also discuss how our portfolios are currently positioned to potentially benefit from these investment themes.

“We believe Italian and Spanish SMIDs are positioned favorably to benefit from the ongoing, gradual recovery”
Growth?
Are we there yet?
The euro area should continue to recover as it emerges from the recession of recent years. Economic data has been consistently picking up over the last two years: the Purchasing Managers’ Indices (PMIs), which track the investment intentions of private companies, have improved in the core, as well as all five periphery countries (Spain, Italy, Portugal, Ireland and Greece), where they have been in positive territory (i.e. above 50) since the beginning of the year. We therefore believe that the region will register a GDP growth rate of around 1.2% in 2014 (1.4% in the core, and 0.8% in the periphery).

We base this outlook on two types of economic indicators which are both showing positive developments. First, leading indicators such as consumer confidence have been rising across the Eurozone for most of last year. Second, real economy data has started following suit, improving from a very low base. For example, during the recession, car sales fell 50% from their pre-crisis levels in the periphery. Recently, the demand picture has changed, with sales improving from depressed levels and with stretched car life expectancy. Retail sales have also started to pick up, and this was one of the signals that we were waiting for in order to turn more positive on the periphery.

Peripheral countries have witnessed a steady expansion in exports, due to rapid improvements in their relative cost competitiveness. This was a positive effect of a negative domestic development: high unemployment put strong downward pressure on wage growth. As a result, the first leg of the recovery saw the elimination of the periphery’s current-account deficit, mostly because of a collapse in domestic demand and imports. The industrial production chart (page 7) shows how manufacturing indicators have been trending up across the Eurozone, supporting export growth.
The relative, positive export performance should continue to improve as the global economic situation evolves, albeit at a slower pace than previously.

We believe that there has been a shift in the main driver of the recovery. Real economy data improvements mean that we now expect domestic consumers to start contributing to growth. Given the high operating leverage of European companies, even a small increase in domestic growth could translate into improving operating margins and earnings this year.

We believe that better real economy data will feed through into stronger European earnings. Our models forecasting earnings growth point to a low double-digit growth rate for European equities in 2014, assuming a dividend yield of around 3.4%.

**Euro area: Retail Sales**

Retail sales volume, excluding autos and motorcycles (seasonally adjusted)

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Growth?


Euro area: Industrial Production (ex-construction)
Percentage change, year over year, writing down allowance

Improving Conditions

Yield spread compression in the periphery
The market has recognized Europe’s better economic picture. Rating agencies have validated these developments, by upgrading most of the peripheral countries over the past year and a half. The tightening of sovereign yields (with the periphery progressively closing the gap on the core) demonstrates less concern among investors about sovereign risk in Europe. We had been anticipating the convergence of sovereign yields between the core and the periphery for some time.

We played this theme successfully in our fixed-income investments after adding exposure to peripheral sovereign bonds earlier in the cycle. On an absolute basis, it is difficult to see how yields could tighten significantly from here. We expect them to stay around their current, low levels in the short term, notwithstanding corrections related to specific political events.
A key issue that has yet to be resolved in Europe is the discrepancy in lending rates between core and peripheral companies. Financing is not available at the same price across the region. This makes it difficult for unitary improvements in hiring and capital expenditure to show through at the aggregate level. In Spain and Greece, interest rates are too high for local businesses to invest significantly in their operations.

We believe that, on this front, some relief is on its way. Banks should get more reassurance about the viability of their balance sheets with the Asset Quality Review (AQR) stress tests, to be published in October/November. We expect banks to improve their lending practices once the ECB takes over their new banking supervision role in November 2014. The new regulator will likely improve the consistency of capital provision and lending terms across the region, allowing the market to fix the interest-rate discrepancy problem.

In the meantime, a number of banks have shored up their capital bases. Many European banks have recently recapitalised, either via equity or debt issues, ahead of the upcoming AQR scrutiny and in preparation for the incoming Basel III regulations. European banks have raised €100bn of capital since 2013, and approximately €35bn year to date. Deutsche Bank recently completed an accelerated issue of almost €3bn in new shares; Commerzbank said in March that it would raise €2.5bn, and Greek banks have been raising significant capital this year. The four main Greek banks have recently raised a combined €8.4bn, with the goal of plugging a €21.7bn capital shortfall in the domestic banking system. The Portuguese banks (BCP and BES) are said to be ready to raise €2.5bn in the near future, according to the local press. We believe this is a positive development and leaves the majority of European banks’ balance sheets in significantly better shape than last year.
Economic Reforms Are Due

Reforming Italy and Spain: watch this space...
Italian and Spanish economic data have improved in line with the European developments that we highlighted previously. This is positive, but not sufficient. The two countries have additional work to do in making progress on institutional reforms.

For the new Italian Prime Minister, Matteo Renzi, who has been in power since February, the focus has been firmly on implementing new reforms. In previous editions of Perspectives we discussed how Italy’s key problem has been the lack of growth. A recovery in GDP was one of the economic priorities that Renzi cited in his “100 days” plan. He proposed cutting income tax and improving public administration efficiency to increase the country’s ability to attract foreign direct investment. On the institutional front, his focus has been on long overdue electoral reforms, which we believe, once passed, will enhance his government’s credibility (a Senate vote is pending). The exhaustive list of reforms will take more than the ambitious 100 days that he has given his government, but we still believe that Italy is on the right track to completing overdue structural changes.

The European Parliamentary elections at the end of May represented an opportunity for Renzi to strengthen his mandate, especially as he was not publically elected to his position. His party’s resounding victory allows him to implement his reforms as needed from here onwards and helps us to keep a positive outlook on the region’s willingness to tackle economic and institutional changes in the medium term.

Spain is further down the road of institutional reforms than Italy. Labour reform has been ongoing for some time, and during the first quarter of 2014, Spanish real GDP rose by 0.4% quarter on quarter (or 0.6% year on year), which was the fastest quarterly growth since Q1 2008. This was mainly the result of export-driven profits and large labour cost cuts. Our positive stance would be validated by improving job growth and a recovery in private consumption. Overall, it seems that so far the reforms, which were initially pushed in 2012 by the Rajoy government, have managed to improve competitiveness. Unemployment levels are stubbornly high, but they have stopped rising.

Overall, we believe that Italy has the political conviction in place for further reforms, and Spain still has to tackle several issues, including reducing the fiscal deficit, which is one of the highest in the euro area (the European Commission has a forecast of -5.6% of GDP for 2014). The environment in both countries is supportive of continued institutional reforms. While the pace of change might sometimes appear too slow, we are watching the unemployment numbers in Spain and the competitiveness indicators in Italy, to monitor whether Renzi’s agenda follows through as planned. Later in the year, we also expect domestic demand to show through in both countries as a result of tax and labour reforms.

“Spain & Italy have some additional homework; they need to make progress on their institutional reforms”
ECB Support

ECB – still a powerful backstop
In case of an unwarranted tightening of the policy stance, such as money market tensions, global rate spillovers or the continued appreciation of the euro, the ECB might further lower the interest rate corridor, including a negative deposit rate, or offer new liquidity injections via liquidity operations, including fresh LTROs. The ECB has already acted to this effect in June by offering a package of measures along these lines aimed at credit easing across the Eurozone.

Finally, Draghi mentioned that in the case of a deteriorating medium-term inflation outlook, the ECB would initiate an asset purchasing programme, as short term interest rates will not offer enough manoeuvre room.

Further impairments in the transmission mechanism, in particular via the bank lending channel, would trigger an LTRO targeted towards bank lending or an ABS programme, supported by regulatory changes to encourage a unitary ABS marketplace across Europe. This is where the ECB has stopped with the June actions: while the targeted LTROs are now reality, the ABS programme has only been hinted at as a potential development later in the year.

We believe the ECB will present the markets with a European version of easing some time in 2014. One of the speeches by ECB President Mario Draghi in April laid a clear roadmap for potential catalysts to ECB action. Before he actually acted in June, Draghi presented three main scenarios:

“The likelihood of large scale QE is small while the PMIs are trending up from current levels”
One worrisome factor in the euro area has been the divergent and declining inflation rates in both the core and periphery. Low inflation combined with a strong currency constitutes a serious cause for concern for the ECB. While 80% of the difference between the current 0.6% Eurozone HICP inflation rate and the price stability objective of ‘below but close to 2%’ is due to lower energy and food prices, other factors are also being considered, and one of the important ones – as Draghi has repeatedly stated – is the euro.

In response to falling inflation expectations in the Eurozone, the ECB announced a series of fresh easing measures in June. Not only did the ECB implement the broadly anticipated rate cuts, but it also delivered on additional stimulus to support existing bank lending and the transmission of low rates to the real economy. We would emphasize that further action from the ECB is on the cards.

After voting unanimously in the June Council on the agreed measures, Draghi stated forcefully at the press conference: “We aren’t finished yet.” While the current package needs time to feed into the economy, we expect the ECB to remain open to asset purchases later in the year should economic data and/or inflation deteriorate. The ECB will continue to support the deleveraging process that banks are carrying on, providing enough liquidity to facilitate credit growth through the targeted LTROs.

For the Eurozone to emerge from recession, two-fold action is needed. The ECB has the keys to creating the conditions for short-term boosts in European demand, while governments need to implement their domestic medium- and long-term structural reform plans.
Why SMIDs Now?
Why SMIDs Now?

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In an environment where structural reforms should eventually unlock employment and domestic demand, we believe that operational gearing should allow European companies to generate strong returns as their operating margins improve from a very low base. For example, Italian and Spanish equities are at half the level of earnings achieved in 2007. As European equity valuation multiples have run in 2013, depressed margins show that there is still room for improvement, while operating leverage will contribute positively to returns.

Earnings are recovering from Very Depressed Levels

Indexed earnings per share (31/12/1998=100)

In all periphery countries, PMIs have been positive since January.

Today €35bn
€100bn

European banks have raised €100bn of capital since 2013 and €35bn year to date.

In 2012 Italian car registrations were lower than in 1980. They’ve been trending up ever since.

Midcaps in Europe outperform when PMIs are accelerating – as is the case now


Typical returns when PMIs are weak

-3% to -1%

Returns when PMIs are on the rise

3% to 8%

Source: Datastream, IBES. May 2014.
We expect European small and mid-cap companies, especially in Spain and Italy, to continue to outperform large-caps in a recovery scenario as they are geared to the domestic side of their economies. The current economic environment is supportive for mid-caps: this section’s chart shows how mid-caps in Europe outperform when PMIs are accelerating - as is the case now. Furthermore, our models show that small- and mid-cap companies do best in an environment such as now, when the euro strengthens, volatility stays low, the economy is improving (European retail sales are trending upwards) while central bank rates are low. Since an improvement in consumer sentiment and fundamental data are on the cards in the near future, and rising rates are not yet a risk in Europe, we believe that Italian and Spanish small- and mid-sized companies are positioned favorably to benefit from the ongoing gradual recovery in the region.

SMIDs in the periphery offer a specifically targeted exposure to the sectors that we believe are bound to benefit from the recovery in those economies. When analysing the MSCI Europe SMID sector breakdown, we note the largest exposure is in cyclically-oriented, domestic sectors, such as consumer discretionary, industrials and information technology. Also, from a geographic perspective, SMIDs have a higher proportion of their business exposed to domestic and Western European economies (54% of overall revenue, as compared to 44% for the broader, large-cap market benchmark).

**Italian and Spanish SMIDs tend to outperform when the European economy accelerates**

**12 Month direction of change in European PMI**

<table>
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<th>Year</th>
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<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
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<td>Accelerating</td>
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<td>1%</td>
<td>-2%</td>
<td>-10%</td>
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</tbody>
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MSCI Europe Sector Breakdown

- Utilities: 4%
- Telecommunication Services: 5%
- Materials: 8%
- Information Technology: 3%
- Industrials: 12%
- Health Care: 13%
- Financials: 23%
- Energy: 9%

MSCI Europe SMID Sector Breakdown

- Utilities: 3%
- Telecommunication Services: 3%
- Materials: 9%
- Information Technology: 8%
- Industrials: 24%
- Health Care: 6%

Source: MSCI as of May 2014
We believe that valuations are also supportive at this point in the cycle. Small-caps typically trade at a 20% premium to the broader large-cap market. During times of economic expansion, however, this premium tends to widen to the 30% - 40% range. With current valuations at a 20% premium and the European economy recovering, we believe that there is upside potential for valuations from current levels.

We believe that SMIDs in Italy and Spain are particularly well anchored to the developing recovery. Earnings growth has already started to reflect the sector’s better prospects than the broader market.

**In 2012 Italian car registrations were lower than in 1980. They’ve been trending up ever since**


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**Earnings are recovering from Very Depressed Levels**

Indexed earnings per share (31/12/1988=100)

Source: I/B/E/S as of May 2014
We discussed before how the indicators which first signaled the decline in Italy and Spain are now likely to be the driver of consumer demand pick up going forward. Our bias was to find those companies most reflective of those indicators. The sector breakdown of the Italian and Spanish SMID indices shows significant exposure to our preferred cyclical sectors (financials, industrials and consumer discretionary). We showed how the purchase of cars – the biggest discretionary household expenditure – is witnessing a turnaround. In early 2012, Italian new car registrations were at lower levels than in 1980; they have been trending up ever since.

The picture for financials in both countries also looks stronger than in the past. The deleveraging of the Italian banking system is starting to show results; large banks have cleaned up their balance sheets. UniCredit and Intesa Sanpaolo have created internal bad banks to manage bad loans, and increased coverage ratios. Monte dei Paschi di Siena initially planned a €3bn capital increase, according to press reports, and its shareholders approved an enlarged €5bn one a few months later. The Spanish banking system has shrunk from 45 large banking groups to 15. The system also has the SAREB, a bad bank which holds €100bn of gross bad loans. Bad loans are now declining for the first time since the crisis, and this is helping banks’ profitability.
Conclusion

Right place, right time for SMIDs
“We believe that SMIDs are the right part of the market to invest in at this point in the economic recovery”

European markets are reflecting the growing confidence in the recovery as indicated by better economic activity. We have benefitted from the compression in sovereign yields and have taken profits on our peripheral bond trades in our J.P. Morgan Private Bank discretionary portfolios. We believe that equities offer good opportunities for plays on the recovery in Europe, especially in the periphery, which is coming back from a recession marked by the lowest levels of consumption seen in decades. We have built exposure to SMIDs in Italy and Spain in our portfolios. These businesses have exposure to domestic consumption, which we expect to accelerate over the coming year. With policy rates in Europe still low, and set to stay so for some time, we believe that SMIDs are the right part of the market to invest in at this point in the economic recovery.

Furthermore, they are well positioned in the developing M&A cycle in Europe. Flows are also supportive; slightly more than half of the equity flows that have left European equities since 2007 have now returned. Renzi’s victory in the European Parliamentary elections is a signal that the positive momentum in the region is on the right track. His electoral success enables economic reforms to follow in Italy as promised and is an important catalyst for the confidence momentum in Europe. The Spanish and Italian economies are now waking up from years of slumber. Small-and mid-cap companies allow us to monetize the slow ride up from the recession’s troughs.
César Pérez
*EMEA CHIEF INVESTMENT STRATEGIST, J.P. Morgan Private Bank*

César Pérez is Chief Investment Strategist for Europe, the Middle East, and Africa (EMEA) and a member of the Global Investment Committee. César has worked in investment management across all asset classes and regions for both institutional and private clients for the past 20 years, including two years at Credit Suisse Asset Management as head of equities, five years at M&G Investments in London and nine years at J.P. Morgan Investment Management in Madrid, London and New York. His interviews have appeared in the Financial Times, Les Echos, Il Sole, La Stampa and Reuters, among others. César specialised in management and industrial organisation at Instituto Católico de Artes e Industrias.
Pedro Gil

Pedro Gil is the Private Bank’s EMEA Equity Strategist. He focuses on identifying investment themes, sector trends and stock recommendations within European equities.

Before joining the Private Bank in July 2013, Pedro spent 9 years in finance working in different capacities. Pedro joined from Santander Global Banking & Markets, where for the previous two years he was the lead publishing analyst covering the European food manufacturing and home personal care industries, including Nestlé, L’Oréal, Unilever, Danone, Reckitt Benckiser, Beiersdorf and Henkel.

Previously, he was a Research Analyst at SAC Capital Advisors, a $15 billion equity long/short hedge fund, based in New York; and prior to that he focused on equity long/short strategies at Fortress Investment Group, a $45 billion alternative asset manager, also based in New York, within the Drawbridge Global Macro fund. Pedro began his career as a Financial Analyst at Goldman Sachs’ Investment Banking Division in New York City.

Pedro studied Law and Business Administration at Universidad Pontificia Comillas ICADE in Madrid, Spain.
Livia Constantinescu is an Investment Strategist in the J.P. Morgan Private Bank CIO Team, focusing on economic and financial market analysis as well as asset allocation and portfolio strategy for Europe, the Middle East and Africa. She is based in London.

Prior to joining J.P. Morgan in 2010, she worked as a merger arbitrage and special situations equity analyst. Ms. Constantinescu holds an MSc in Finance from London Business School, with a concentration in Investment Management.
Julien Lafargue, CFA, is a member of the Global Equity Strategy team at J.P. Morgan Private Bank, covering European Equities and focusing on identifying investment themes, sector trends and stock recommendations within European equities.

Since joining J.P. Morgan in 2008, Julien has held various positions as a Mutual Fund Product Specialist and in the Alternative Investments Support team.

Julien is a CFA charterholder and holds a BA in Finance and an associate degree in Information Technology.
Important Information

Abbreviations

ABS – Asset backed securities
AQR – Asset Quality Review
ECB – European Central Bank
EPS – Earnings per share
Euro area/Eurozone – The economic and monetary union of 18 European Union member states that have adopted the euro as their common currency
EU – European Union, an economic and political union of 28 member states
GDP – Gross Domestic Product
HICP – Harmonised Index of Consumer Prices
LTRO – Long Term Refinancing Operation
OMT – Outright Monetary Transactions
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