News

Europe: Where are we now?

JOHCM Continental European Fund

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25 Mar 2022

Rarely over the last decades has the outlook changed so much in such a short period of time, from a quasi-post-Covid boom to the horrors of the invasion of Ukraine and the unfolding humanitarian disaster. Recent European prospects, as I wrote about at the beginning of February, have been very bright so the need now is to evaluate to what extent this may have changed. The context is that the direct exposure of the Eurozone to Russia and Ukraine is very low, with exports only 0.6% of GDP, having not recovered since the large decline after the 2014 invasion of the Crimea.

At the company level, whilst most large-cap European companies will have some Russian exposure, in the vast majority of cases it is less than 2% of revenue. However, the most important focus of this time is Europe's energy dependence on Russia, which stands at a third of gas consumption and around 20% of oil, with certain countries such as Germany and Italy importing nearer to 50% of their gas needs from Russia. Again, purely in an investment context, most roads lead to energy price effects when you look at the growth and earnings consequences of the crisis.

GDP growth in Europe had been forecast at close to 4% for this year and whilst the European Central Bank (ECB) still forecasts 3.7% in its March staff forecasts, a more realistic number is probably closer to half the previous forecast. The majority of this incremental fall would be attributable to the higher oil and gas price effects, with further effects from tighter financial conditions and lower economic confidence from all parties in the economy. As I write (16th March) the good news is that Brent oil whilst peaking at $128pb is now $99 vs $94 the day before the invasion, whilst Dutch gas prices peaked at €227 per MWh and are now at €111 vs €88 the day before the invasion. As regards gas, clearly many consumers have yet to see the rise in their bills from the fourfold increase in wholesale

prices from the middle of 2021. We have seen that Europe has been quick with sanctions but have naturally not sanctioned (unlike the UK or US) Russian oil or gas. There remains a possibility that the Russians could turn off the taps, but with 70% of their gas exports travelling towards Europe in the search for hard currency this remains a possibility rather than a probability at this point.

The European Commission (EC) has published its REPowerEU plan, a response to current events, which focusing on the security of energy supply and targeting a reduction of Russian gas imports by two-thirds by the end of 2022,a challenging goal. In the short term the plan revolves around more LNG imports, more pipeline gas from elsewhere and more coal. The plan seeks to reduce Russian gas demand to zero by 2030, particularly through an even faster growth in renewables from 45% of the power mix today to 75%. Europe is quite obviously dependent on Russian imports for at least the coming years and any cut-off type scenario would most probably lead to recession due to the huge spike in global prices. The ECB estimated in January that rationing even 10% of gas would reduce gross value added by 0.7%. So whilst recent moves in energy prices have been reassuring, the obvious base case is that they will stay higher for quite some time longer.

The question remains what European governments can do to safeguard growth and in this respect the Eurozone benefits from relatively low indebtedness. On this point the fiscal impulse is set to be high. In the immediate reaction to the crisis Germany announced a one off €100bn defence investment and all members are committing to defence spending at the NATO targeted 2% of GDP level (vs the current c1.5% on average). Naturally the spending focused on the energy transition is set to be very high. The commission president Ursula von der Leyen recently described the Green Deal now as a “strategic investment” and we remain convinced that Europe has top decile environmental goals. Even if in the short-term carbon-intensive energy may be the temporary answer to cushion the goal of reducing Russian imports. On the energy side of things we will hear more in the near term about the possibility of consumer energy price caps, with disposable incomes set to be hit by the combination of energy and food price rises. There will likely be further developments in European joint financing for some of these post-crisis projects, as with the Recovery Fund where the commission issued bonds on behalf of the EU. Certainly the Recovery Fund has some scope to soften the economic blow of the war given 2022 and 2023 are the two biggest years for distributions.

The effect of the crisis on inflation is considerable. The ECB now forecasts 5.1% at the headline level but it could easily be between 5-7% dependent on the path of energy prices. Elsewhere food prices are set to race higher, with Russia and the Ukraine accounting for some 28% of wheat exports, 16% of corn and 50% of the global trade in sunflower oil, with the vast majority exported via the Black Sea ports. Given nearly all these exports are likely to be lost and plantings imperilled it is no exaggeration to say that food shortages in poorer countries are possible, meanwhile in the developed world food price inflation is set to be incredibly high.

Wage growth in Europe has been sub 2%, but with real wage growth severely negative it would seem clear that upward pressure will be asserted. The ECB’s recent meeting was more hawkish than expected, perhaps not wholly surprising given their single mandate of price stability whilst safeguarding “financial stability”. Whilst they do forecast HICP to fall to 2.1% next year, the ECB did spell out the possible ending of QE by the summer, with purchases ratcheting down from €40bn in April to €20bn per month by June and “data dependent” decisions thereafter. Interest rate adjustments would only take place once QE has wound down and “will be gradual”, so the likelihood is that we will start to see gentle rate rises from Q3 onwards. The market currently prices in 63bps over the next year (vs 197bps in the US and 174bps in the UK). So the good news is that Eurozone rates are coming up from a very low nominal level (minus 50bps) and will be slow paced versus the rest of the world.

We have seen a roll call of companies announcing the ceasing of trading in Russia, to varying degrees of permanence, due to a combination of moral principle and shareholder and customer pressure. Energy companies are clearly at the forefront of the shift. The supply chain effects of the crisis are still working their way through; Volkswagen for example is amazingly still at 30-40% capacity in its wiring harness sourcing from the Ukraine but for how much longer shall remain to be seen. Elsewhere

the effects can be quite specific such as semiconductors or neon gas or less specific in the shutdown of imports of fertilisers, aluminium and certain precious metals such as palladium. The untangling of Western company's connections to Russia will clearly take some time and the effects are hard to estimate other than to think none of this will be positive for profitability. A month ago the forecast of 7% earnings growth this year looked woefully low. Now it looks too high and a low single digit positive number looks more likely, with the potential for an acceleration again next year.

We were confident for the prospects of our overweight positions in automotives and financials through the winter quarter, but clearly a lot has changed since the last week of February and we have altered our stance accordingly. We are now more neutral in financials and underweight in automotives. The reason for previously liking banks revolved around rate rises, strong capital, high dividends and the extent to which they are leveraged plays on a strong economic outlook. With the latter having taken a knock and given the effects of higher energy prices for consumers and businesses, it becomes sensible to price in a higher cost of risk / provisioning for 2023 onwards, from below normalised levels to slightly above normalised levels as well as slightly lower revenue trends. There are clearly 2022 one-off effects for Banks with Russian exposure, in terms of subsidiary write-downs to zero in most cases and write-downs on Russian related offshore loan exposures, but rarely are they likely to consume much more than 100bps of core capital. So far all banks, except the Russian centric Raiffeisen, are committing to pay dividends in the coming season but clearly 2021 dividends paid in 2022 will take a large hit, nor now are 2022 buybacks likely to take place for the most affected banks.

Automotives benefit from significant pent up demand from the semiconductor shortages of 2021 and are a great play on electrification, but new supply chain problems are likely to prevail and inevitably consumer demand, particularly at the more mass market level, is set to be lower. Elsewhere, we have chosen to reduce position sizes in those companies which will be affected by surging input cost inflation, mainly within the industrials sector.

Equity market selloffs are never disciplined affairs and are most often driven by positioning going into the crisis and often the tight risk limits of hedge funds. This has in itself presented a number of opportunities in specific stocks, where the focus is on buying companies with strong franchises giving an ability to have strong relative pricing power against an inflationary backdrop. We have taken new positions such as in SAP, Adidas and Universal Music Group amongst others. The Adidas shares have fallen nearly 40% from the highs of last year, leaving a company with a 28% ROE and recent guidance for 11-13% revenue growth trading at under 18x next year's earnings. We have added to luxury goods, both the existing position in Richemont and a new position in LVMH. There have been fantastic opportunities to add to the likes of Deutsche Telekom and ASMI. At the sector level we are now higher in technology, communications and healthcare.

Fundamentally the equity market tight rope will be hugely determined by how long the war lasts and the effects on energy prices over the short and medium term. We hope that recent signs of a negotiated compromise come to fruition but we shall see. It is no wonder that Europe has seen severe outflows over the last two weeks, leaving the index looking inexpensive by historical standards. We are now in a world where 2022 growth is set to be lower and inflation higher, but we shouldn't forget that Europe is likely to act far more cohesively in the future, which may mitigate the higher risk premium from the crisis.

The lesson of the covid crisis was that Europe emerged stronger, with the obvious caveat of the gas taps being turned off, we think this is likely again. We strongly believe the central case is absolutely not that Europe will go into recession, far from it, and interest rates will not pose a significant headwind as they likely will do in the US. Instead a relative monetary tailwind persists.

Given the fluidity of the crisis, the world could be very different in another month, but the underlying coherence of European economic recovery remains solid for now and we will remain proactive in managing the fund.

An overview of the fund can be found here.

Note: Data from JOHCM, MSCI Barra or Bloomberg (unless otherwise stated)

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02 February 2022

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