More Than Lipstick?

Are the euro zone's peripheral markets a true recovery play? By Eric Uhlfelder

Time has a way of taking the edge off harsh realities. But forgetting how things were can be a very expensive mistake.

Greece, not so long ago, was the extreme epitome of Europe's worst: fiscal mismanagement, inflexible labor markets, soaring joblessness, broken balance sheets—refusal to squarely face reality. And these issues were found hanging over much of the continent's troubled periphery.

But in 2013, Greek shares soared by more than 46% in local currency terms, according to MSCI. Irish stocks climbed 36.5%, Spanish stocks 26.5%. Portugal and Italy registered modest gains. (See Figure 1.)

The rally was triggered in large part by the pending return to growth. Though Ireland's three-year recession ended in 2011 with GDP having expanded an average of 1% over the last three years, the other countries in the group known pejoratively as "PIIGS" (Portugal, Ireland, Italy, Greece and Spain) were mired in longer economic contraction that cumulatively chopped off economic activity, by 6.20% in Spain and by nearly 23.5% in Greece. The International Monetary Fund now projects growth to return to all the markets in 2014.

Current account balances as a percentage of GDP have also been on the mend, with four of the five countries having posted positive numbers in 2013. The IMF projects Greece's ratio to turn positive this year.

Collapsing interest rates have also been an encouraging trend. Since early 2012, Greek 10-year sovereign yields fell from 30% to less than 10%, while Portugal's fell from the mid-teens to 6%. And Italy's, Ireland's and Spain's high-single-digit yields have normalized below 4%.

Private equity flows—a possible read of what smart money is thinking—has been surging back into Southern Europe, according to the data tracker Preqin. Stuck under €500 million from 2010 through 2012, PE surged above €1 billion last year. In late February, venerable hedge fund managers George Soros and John Paulson each invested €92 million in a new Spanish real estate trust—a sector that was at the economic front of the country's collapse.

And in December, the Purchasing Managers Index—an indicator of future economic performance—broke 50 across each of Southern Europe's troubled markets, indicating expansion. And in January, the number grew even larger.

FIGURE 1

As The World Turns

YEAR	ITALY	SPAIN	IRELAND	PORTUGAL	GREECE	US	WORLD
MSCI INDEX							
2014*	15.72%	7.25%	14.50%	10.55%	6.47%	2.45%	2.49%
2013	16.08	26.58	35.59	7.42	46.05	33.62	27.37
2012	11.72	3.12	4.66	3.36	4.11	16.44	16.54
2011	–23.18	–12.28	18.12	–19.33	-61.42	1.08	–5.02
2010	–8.10	–15.65	–12.00	–4.25	-40.89	17.28	12.34
2009	24.01	40.55	9.36	37.27	21.42	28.76	30.79
2008	–46.57	–40.60	–36.96	–49.19	–64.31	–37.04	–40.33

SOURCE: MSCI.com. *From Jan. 1–Apr. 30, 2014.
All country performance is in local currencies and are gross returns. World performance is in U.S.D.

So does all this mean the PIIGS are out of the woods?

For short-term investors, the answer is yes. Money has been made and will be made as GDP growth and profitability return on the backs of falling labor costs and increasing domestic competitiveness and as more investors are lured by the prospect of continued revival. "The recovery is real and the worst is behind us," claims Jing Sun, who manages $136 million in global portfolios for Centre Asset Management.

However, Eric Stein, who manages the $5 billion Eaton Vance Absolute Return Fund, a conservative cash-plus fund, thinks otherwise. His fund has no long eurozone exposure because he thinks ECB policy, rather than fundamental improvements, has been driving the credit and equity rally.

Sun counters by saying there is mounting evidence that serious reforms are paying off. Accordingly, he believes that local governments will have an easier time pushing through additional structural changes, despite the hardships they engender.

That will be the key for longer-term investors. Systemic problems that sent these economies into tailspins are still far from fixed, and they remain vulnerable to poor extant economic conditions and deficiencies of common currency. Understanding the latter requires a look back.

Euro Blowback

Two decades ago, European leaders had devised standards to determine which nations were responsible enough to join the euro—even though they often closed one if not both eyes in waving suspect nations through admission.

Furthermore, the plan never agreed on a means to effectively deal with—even expel—member economies turned dysfunctional. Making things worse is that when nations stumbled, they no longer could count on a reviving jolt that would come from the subsequent weakening of their currencies. And this change is now a key problem.

Pre-1999, before the euro, currency devaluation was a relief valve for troubled economies. A weakening currency would lower the cost of locally produced products, services and securities to foreigners, even before structural reforms were put in place. Devaluation alone could help jump-start a faltering economy, albeit without necessarily fixing it.

Some may argue that without this relief valve, troubled economies now must effect essential reforms before they see any improvement. This may ultimately lead to a healthier eurozone down the road. But it means that hard times last longer.

With the eurozone lacking a game plan to deal with such difficulties, what investors saw during the banking meltdown of 2010 and 2011 was the European Central Bank and its constituent members making up answers on the fly. Markets generally don't respond well to such uncertainty. Greek stocks proceeded to lose nearly 80% (in local currency terms) during these two years, according to the global index tracker MSCI.

But it wasn't just Greece that investors

Caveats

MUCH OF THE PIIGS RALLY HAS BEEN FUELED BY HOT MONEY MOVING OUT OF TROUBLED emerging markets. That suggests that when the music pauses when labor costs move back up, capital may start flowing out to some new opportunity. So when the first tremors of uncertainty are felt, rising asset values will be vulnerable to substantial correction if sufficient reform hasn't been achieved.

Don't count on exchange rates to be a barometer of future macro difficulties for Europe. It hasn't been so in the recent past, with the euro having held up despite all the bleak news coming out over the recent years.

If the euro continues to hold or appreciate in value versus the dollar, that's good news for U.S. investors, who will benefit from the appreciation. And while risk of a euro breakup is off the table for at least the next several years, the forward value of the euro is as uncertain as exchange rates always are.

Ian Stannard, Morgan Stanley's head of European currency strategy, sees the euro zone facing deflationary pressure from "disappointing growth prospects and constrained credit dynamics, especially at the periphery of the euro zone." He thinks that further monetary easing will weaken the euro.

So if one assumes the U.S. recovery is ahead of Europe's, and that higher interest rates will occur first in the States, then we may see a weakening in the euro as money chases higher returns. If the euro weakens by 5% over the next two years against the dollar, then the dollar value of euro zone investments will take a comparable hit.

feared. Increasingly indebted government, overextended consumers, rising joblessness, banks socked by overleveraged balance sheets and ownership of local troubled sovereigns and busted housing booms across the eurozone's periphery revealed a region ripe for contagion as investors started to look more suspiciously at some of Europe's former tiger economies—especially Spain and Ireland.

FIGURE 2

Value Of The Euro Vs Dollar: 2008–2013

SOURCE: Oanda.com

With the eurozone thought to be structurally suspect and given concerns about the currency's breakup, the euro has remained surprisingly strong since the start of the financial crisis. However, with the U.S. having emerged earlier out of recession, the likelihood of U.S. interest rates rising before those of the euro zone could push the dollar higher, potentially hurting U.S. investors with European equity exposure.

Common Cold

The five economies that came to define Europe's most troubled economies—Portugal, Italy, Ireland, Greece and Spain—vary significantly in terms of core sectors that drive their economies. The largest company by market cap in Ireland is CRH (a construction supplier); in Spain it's Santander (a global bank); in Greece it's Coca-Cola HBC (a bottler that relisted in London last year to minimize its home country stigma).

But these economies do share three common ailments. One, they all got drunk on instant cheap money that came with eurozone membership. The profligate Greeks and Italians were able to borrow at close to the same rates as highly disciplined Germans.

Two, peripheral economies and the ECB lacked the regulatory discipline and oversight to identify and respond to excesses fueled by access to cheap money. And three, domestic and foreign investors (being short-term profit focused) failed to note rising systemic risks.

In early March 2014, Spain, Italy and Ireland 10-year sovereign yields were within 200 basis points of German bunds, reviving the question: Is risk again not being accurately assessed today among the eurozone's diverse economies?

Not an issue to Barry Norris, portfolio manager of the London-based Argonaut European Alpha fund with £255 million in assets, which has been averaging gains of more than 13% a year since starting up in 2005. He sees opportunities across Southern Europe over the next several years because of the significant gap he sees between near-term consensus market earnings and what he expects will be made as economies emerge from recession. Accordingly, he has boosted the fund's exposure to the region from nil as of the end of 2012 to 30% in February with positions in leading regional banks and industries.

"This is not much different from what was happening in the emerging markets in the late 1990s," explains Norris, "when we saw the collapse in growth and corporate profits and deep cost cuts. A key difference: Southern Europe has had to do this not through the currency devaluation but through the devaluation of labor and production costs." He sees the region as more competitive and ripe for earning surprises, far more so than Germany and Switzerland, whose exposure he has ratcheted back from 60% as of the end of 2013 to just 12% this past February.

However, the more skeptical Andrew Parry, chief executive officer of Hermes Sourcecap, a £1.7 billion high-alpha European strategy, isn't quite so sanguine. In labeling the current rally as a "rush for trash," he thinks investors may be "forgetting the lessons of the past and failing to ensure these cheap companies have the fundamental strength to keep delivering the goods over various economic cycles."

To Parry, absolute values are now looking quite high, so investors will have to be selective because he doesn't think the recovery will float all boats. Specifically, he needs to see evidence of earnings power that justifies the re-ratings and higher prices.

If Parry is right, then advisors who may opt for simple, easy exposure through ETF country funds may find more risk in such broad diversification than through selective exposures to sound companies with proven management and healthy sales diversification.

Opportunities

To find opportunities in economies that are recovering, identify the sectors that respectively drive them.

Financials dominate Spain (47%), Italy (33%) and, to a lesser extent, Greece (19.50%) by market cap. But in Ireland, materials (27%), consumer staples (23%), and industrials (23%) are the dominant sectors. And in Portugal, utilities (26%) and consumer services (23%) make up half the market.

The reason banks were among the worst hit stocks (because of their leverage to the economy and direct exposure to the sovereign debt crisis) is the same reason some investors see them today as among the most compelling plays. The key reason: ECB president Mario Draghi's pronouncement in July 2012 that the bank would do "whatever it takes" to backstop the region from imploding. Whether correct or not, many investors read this as an "all clear sign."

Banks were big winners of this commitment, according to Richard Nield, manager of the $1.6 billion Invesco European

continued on page 98

Growth Fund. They used cash infusions from the ECB's Long-Term Financing Operations (LTFO) to buy sovereigns, which helped bring down rates and boost the value of their own balance sheets.

As plays on reviving domestic growth, Nield favors large locally focused banks, with market caps of more than €5 billion, as a means of leveraging economic recovery. But he warns that the revival has to involve more than financial engineering. "Without real turnaround in the macro environment," says Nield, "it's hard to imagine that we'll see material improvement in sales growth, operating margins and profits."

The portfolio manager of the $3.5 billion BlackRock International Opportunities Fund, Nigel Hart, who realized gains of more than 22% last year, also sees opportunity in some of the region's banks, especially after having seen some trade down as low as 0.5 times their book value. "Banks got badly hit by the sharp rise in non-performing loans and collapsing sovereigns on their books," observed Hart. "The industry should likewise benefit from improvement as these trends reverse."

Argonaut's Norris is also sanguine on the banks. Since the middle of last year, he's committed 15% of his portfolio to Italy's Intesa Sanpaolo, Spain's Bankia, and Greece's Piraeus. "As new investors, we see substantial upside from restructuring and recapitalization," explains Norris. "And as non-performing loan provisioning peaks and banks start to shift such assets back into P&Ls, coupled with a larger percent of operating earnings flowing directly into profits, we should then see re-ratings and higher stock prices."

The portfolio specialist of the T. Rowe Price European Stock Fund, Andrew Clifton, says that despite the recent run-up in Spanish stocks, he still thinks many companies are still trading at a discount to fair value, especially cyclicals, whose recovery potentials still haven't been priced into their shares. The fund also favors noncyclical utilities Gas Natural Fenosa and Enagas, which continue to offer relatively predictable earnings at attractive valuations, despite both having moved up sharply since the fund purchased them in mid-2012.

The Irish economy, which was the first of the PIIGS to escape recession in 2011 and which Norris almost hesitates to group with troubled Southern European markets for its more aggressive response to difficulties, is home to many large successful enterprises. Argonaut holds a position in building supply manufacturer CRH, which last year enjoyed sales of €18 billion. And since its shares bottomed out in the third quarter of 2011, the stock has more than doubled.

While manufacturing isn't a lead driver of the Italian economy, Philippe Brugere-Trelat, manager of the $2.8 billion Franklin Templeton European Fund, is keen on the high-end tire maker, Pirelli. Though he's far from convinced that PIIGS can fly, he likes this global industry leader. This helped the stock power through the euro crisis; it's up fivefold since the start of 2009. Brugere-Trelat sees further upside as the company expands its presence in the replacement market and anticipates a shareholder structural change when the CEO announces his retirement. FA