

MAY 20, 2010



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European stocks at bargain levels

Well-suited for currency-hedged portfolios

These are confusing and unprecedented times for investors. Over the last couple of years, we have witnessed the deepest market correction since the Great Depression, followed by the fastest rebound ever. Remaining calm proved to be a true test of patience.

Once again markets have entered a period of instability with concerns mounting over the recovery of the global economy. Investors worry about the state of affairs in the Eurozone and whether the nearly \$1 trillion injection will be enough to maintain confidence in the euro and prevent another credit crisis.

This uncertainty has translated into fear, causing investors to begin a flight to safety. However, one must ask whether the pandemonium actually opens the door to opportunity for investors with currency-hedged portfolios.

According to Credit Suisse, Continental Europe is a lot better off than pessimistic headlines suggest. Aggregate leverage in Europe (including consumer, corporates, and government) comes in at 220% of GDP - well below that of the US at 270%, the UK at 300%, and Japan at 363%. And the savings ratio in core Europe is six times that of the US.

Meanwhile, valuations in Continental Europe are quite cheap. The sector-adjusted P/Es are close to all-time lows versus the US, and its dividend yield is near an all-time high. Currently, 47% of the total European market cap offers a dividend yield that is higher than government bond yields. The weaker euro may have furthered negative investor sentiment but Credit Suisse has found that 88% of the time the euro weakens, Europe outperforms.

And yet, there has been a tremendous amount of capitulation in the foreign markets as investors have been selling in high volumes. Global equity funds currently have the lowest allocation to Continental Europe since 2004 and fund outflows have been extreme since March.

While the global economy is clearly not out of the woods, there is reason to be optimistic. Interest rates remain exceptionally low and there is still a massive amount of liquidity in the system through a combination of stimulus and bailouts. As a result, there are some key overlooked areas that appear attractively valued.

While the majority of investors have focused solely on issues in Greece and peripheral Europe, regions in core Europe offer a far more interesting story. German GDP is 50% larger than that of peripheral Europe and contributes 27% of the Euro region GDP. In comparison, the combined GDP of Portugal, Ireland, Greece, and Spain is 18%.

Credit Suisse anticipates that Germany will benefit from increased GDP growth, with the best leading indicators (PMI, IFO) pointing to 3% or higher. Germany has the least leveraged balance sheets, undervalued housing markets, a budget deficit just 1.4% of GDP, and low unit labour costs. It is also the second biggest exporter globally, and therefore benefits when the euro declines.

Risk-averse investors looking to gain access to Germany could purchase an exchange-traded fund such as the iShares MSCI Germany Index. Those looking for individual holdings should be very selective with

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their stock picking and ideally seek conservative yield plays with prospects for growth. Investors should also look for core European stocks that are cheap relative to their US peers.

Rather than panicking, investors are best served by calmly examining the facts. Too often, investors miss excellent opportunities because they follow the pack instead of soberly assessing the investing environment and searching for opportunities that are not immediately apparent.

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