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MARKET INSIGHT

EUROPEAN RECOVERY HELPED BY ONGOING REFORMS

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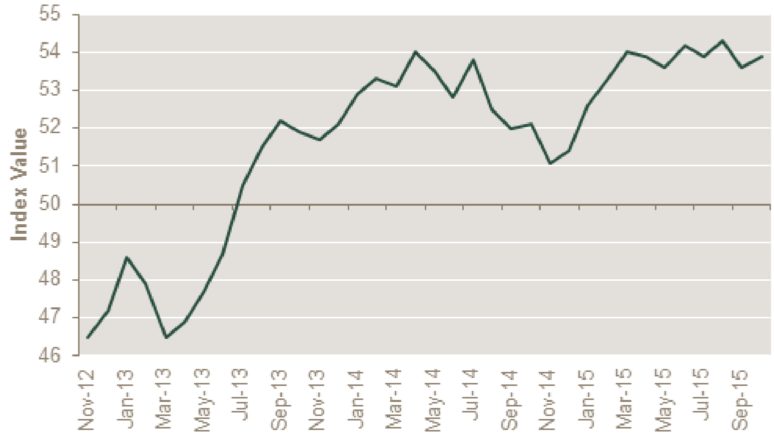
European equities started the year with a bang as the hype of the European Central Bank's (ECB) quantitative easing programme boosted markets. The positive sentiment later turned negative as weaker economic data out of China signalled a slowdown in the world's second largest economy, and investors and the Federal Reserve alike were uncertain over the future of US monetary policy. However, over the last few months positive news from Europe has yet again encouraged the market and we are now back near the previous highs hit earlier in the year.

Encouraging economic health

Purchasing Manager's Index, an indicator of the economic health of the manufacturing sector, remains strong (see Figure 1) and manufacturers across the continent are reporting having to scale up output in response to increased new orders. Eurozone economic growth is also encouraging as the GDP expanded by 0.4% in the second quarter of the year (see Figure 2).

Figure 1: Eurozone PMI

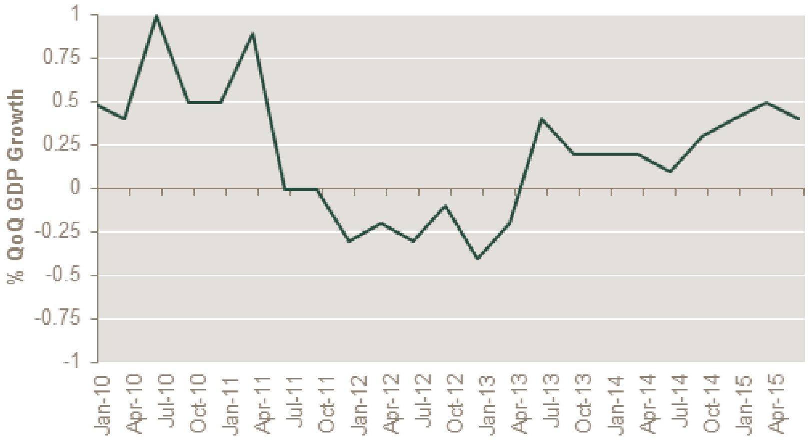
The Eurozone Purchasing Manager's Index remains strong and manufacturers across the continent are reporting having to scale up output in response to increased new orders, indicating a healthy manufacturing sector.



Source: Bloomberg, New Capital Research, 19 November 2015

Figure 2: Eurozone GDP Growth

The Eurozone economy grew by 0.4% in the second quarter and is now firmly in positive territory.



Source: Bloomberg, New Capital Research, 19 November 2015

Labour market reforms are helping countries such as Spain and Italy to increase the flexibility and efficiency of their labour force. Some of these reforms are based on those undertaken by Germany in the early 2000s that helped the country to bounce back quicker from the crisis of 2008/09. Spain has taken the first steps to improve the rigidity of its labour market in an effort to improve productivity and the prospects for youth employment. Labour market reforms are at the centre of the current political campaign heading into general elections and we think a new wave of reforms will be launched after the new government has been formed. Although hard macro indicators are still mixed, we can see a clear improvement and expect that the reforms being implemented across the continent will provide an improving environment for European equities.

Reforms in Europe have not only been focused on tackling economic issues, reforms have also been brought forward to improve the workings of specific sectors. Read on as we discuss three major reforms currently underway: the harmonisation of EU insurance regulation which we believe will spur growth in the sector; the “Popolari” Italian banking reform which aims to renew focus on shareholder value creation; and the ongoing consolidation-reform in the European pulp, paper & packaging sector, driven by the major industry players.

Europe-wide insurance regulation reform

The Solvency II directive for the insurance sector will finally come into effect on first of January 2016. We think Solvency II, which seeks to harmonise the EU insurance regulation, will be a game changer for the industry. Until recently the sector economics have been driven by the capacity to generate cash and distribute it to shareholders through dividends. That is the reason dividend yields have been one of the main valuation metrics in the sector. However Solvency II emphasises more transparency, tighter controls and imposes stricter capital rules, therefore increasing the volatility of earnings and more importantly of the cash generation. The transition to the new framework won’t be easy for the sector, however, we foresee some winners under the new regime. Insurers with good excess and quality capital, a diversified business enjoying economies of scale and a focus on the fee based products will emerge as winners. Once Solvency II is in place we also expect a renewed interest in capital repatriation to shareholders, as many companies are currently hoarding cash and have been adamant not to discuss new capital allocation policies until the new capital requirements have been clarified.

Regional Italian banking reform

Other more regional reforms, such as the Italian banking reform, also present attractive opportunities for equity investors. The dubbed Popolari reform is mandating for a consolidation among banks and a renewed focus on shareholder value creation. To this end the banks have been cutting costs and increasing their exposure to capital-light products with stable and recurring revenue, such as asset management services. We think that independent asset gatherers in Italy are in the early stages of a multi-year growth trend. Further, Italian household savings are currently mostly in Italian bonds which are close to maturity. This has brought many households to seek professional investment advice in order to reinvest and diversify their investment savings. We expect this trend to strengthen further as the Italian economy continues to improve and household savings increase. We also see the upcoming Markets in Financial Instruments Directive (MiFID2), which seeks to regulate how financial services firms operate, as positive for the well-established asset managers in the region that are already compliant with the new fair pricing rules.

Corporate-driven pulp, paper & packaging reform

Some of the reforms are instead some of them are instigated by the main players in an industry. For example the European pulp, paper and packaging industry remains highly fragmented and is suffering from a consumption decline. This has spurred a range of capacity closures, mill conversions and more importantly consolidation. This year so far almost €4 billion in M&A has been recorded but a long tail of potential consolidation remains. Stocks in the packaging sector have performed strongly since 2012 on a combination of the European recovery, the weaker euro, self-help and industry consolidation. We think this is still a valid investment thesis for the sector given the current economic environment in Europe and the structural changes the industry is undertaking.

Final thoughts on a recovering Europe

Identifying attractive Europe-wide, regional and industry specific trends may provide a diligent investor with an edge. Overall, a recovering European economy should spur revenue growth, margin expansion and increased corporate earnings. With earnings up since last year and companies' margins benefiting from lower input costs and currency tailwinds, we foresee sustainable earnings growth for European equities.

Note: Past performance is not necessarily a guide to the future. Returns may increase or decrease as a result of currency fluctuations. Performance is net of fees. Please refer to the Prospectus for further information on this Fund and prior to any subscription.
Sources: New Capital Fund Management, Bloomberg. Unless otherwise stated all data as of 25 August 2015.

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