



# Eurozone Outlook 2013: Poised for Stable Recovery

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If 2012 was the year of being on the brink of disaster in the Eurozone, the year 2013 should be the year of recovery. The world's largest economies (the US, the Eurozone, Japan, and China) all have new governments that are focused on rebuilding from the ground up. This essentially means the implementation of bond-buying stimulus programs and central banks in each of these areas have committed to these programs for

the long term. Because of these commitments, economic data has shown steady improvement and it now looks as if perhaps each of these regions might start to see sustainable recovery next year.

So, what do these long term commitments to stimulus mean for the Eurozone? With tensions easing with respect to the region's debt crisis, key issues will be addressed in the upcoming elections for Germany (the region's main creditor nation) and Italy (one of the region's most indebted nations). The contrasting discussions that will likely take place during the voting process will prove to be highly valuable when looking at the steps Eurozone policymakers

will need to take in order to maintain stability in the region and to create an environment for that is positioned longer term growth.

## **Elements of Uncertainty in Europe: Italy, Spain and Greece**

The upcoming elections in Italy and Germany will also be critical for gauging economic confidence across the Eurozone. Italian Prime Minister Mario Monti has received widespread applause for his work initiating financial reforms in the country but the February elections will be the key in determining whether or not these reforms can continue. In order to prevent major



◀ changes of these reforms, many consider Monti's re-election to be essential for the process, and any electoral disappointments will likely throw an element of uncertainty into markets until the agenda of the next administration is understood.

For many, the problems in Greece have faded from the headlines as the country received its required bailouts, avoided defaults and managed to remain an active member of the European Monetary Union. But this does not mean that the potential for political unrest has been removed, and these concerns could increase if the current coalition government is pushed out of office. There is still a portion of the analyst

community that sees a Greek Exit as a possibility, and popular sentiment within the country could still provide obstacles for the acceptance of EU imposed austerity measures that will be required for in order for the country to receive additional bailout funding.

In both Italy and Spain, recovery programs now hinge on the ECB's proposals for Outright Monetary Transactions (OMTs), which essentially offer the debt-troubled regions a lender of last resort. The OMT funding does not come without costs, however, as the ECB is requiring commitments to strict conditions: sovereign aid would be subject to Troika oversight and real

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commitments to imposed austerity measures. Where officials in Spain were previously anxious to secure new ECB bond purchases (effectively buying the country's debt), those bodies now must re-think this option, as a population in recession might have difficulties with what some consider to be "unrealistic" austerity.

Excessive budget cuts might "cut into" the re-election prospects for any officials agreeing to these measures, and markets are well aware of the potential difficulties that could be created if both sides are not able to agree on an economically viable solution. Regional stock values initially dropped as some of these programs were introduced and negative outcomes were considered. But bond yields have since stabilized as investor confidence slowly returns and the market environment settles into a less volatile mindset.

### **External Risks: UK Credit Ratings and the US Fiscal Cliff**

When looking at potential risks outside the Eurozone, consideration should be given to the increased likelihood that the UK will lose its AAA credit rating. UK government borrowing rates are expected to reach £113 billion, and if we start to see declines in quarterly GDP figures, the risks for credit downgrades will increase. With UK borrowing rates



reaching new highs, the government has received widespread criticism as spending overshadows tax receipts, and the loss its elevated credit rating could bring some stalling to regional stock markets. Both the US and France have received a downgrade from one of the major ratings agencies in the last few years, and a downgrade in the UK would mean higher borrowing costs as investors need additional incentives to buy the country's bonds.

Situations like this only add to market uncertainty (and put pressure on stock prices), but it is important to remember that the policy negotiations related to last year's US Fiscal Cliff story have yet to reach completion. Any evidence of disagreement in these budget talks will not be viewed favorably by stock markets, so it will be important for policymakers to show signs of cohesion into the next round of budget votes. Thus far, most of the focus has been on raising the Debt Ceiling (rather than addressing the real budget issues) and this type of approach is unlikely to keep markets complacent for very long. At this stage, it is clear we will need to see a real commitment to budget restructuring in order to maintain the recovery outlook for 2013.

### **Maintaining the Union, and the "Big Rotation"**

Given the potential negatives that have grown inside and outside the European Union, the next question to ask is whether or not sufficient political determination can be found to keep the EU intact and to prevent a potentially costly exit of any of its member nations. Some of the most encouraging comments have come out of the creditor nation of Germany, where politicians have repeatedly stressed a strong interest in keeping the Eurozone together in



its current form. As we move closer to the country's next elections (9 months from now), it appears that no one, especially Angela Merkel, wants to be the person viewed as responsible for splitting up the Eurozone.

The efforts to create economic and political cohesion have encouraged many investors to start talking about the next phase in the "Big Rotation," which essentially means that market investors will start to move out of fixed income and move back into equities. This creates a very bullish scenario for European stocks in 2013, as the region's long term equity valuations remain near historic lows.

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repercussions for the global economy, there is very little reason to believe policymakers will allow any major sovereign credit defaults to occur. Markets have already prepared for the doomsday scenario and this is the reason stocks in the region have shown price-to-earnings ratios that approach 30-year lows, so continued signs of commitment from EU officials will be supportive for regional investors will long term time horizons.

### **Reasons for Optimism in Europe**

Even with all the outlined risks that are associated with European stock investments in the medium term, reasons for cautious optimism can be found. As a political consensus continues to grow and we see a greater level of acceptance for a gradual implementation of austerity measures, stock values should remain supported. In recent months, market sentiment has been driven more by changes in the political environment than it has by real economic data, so as long as the ECB continues with its guardian stance to protect the union, long term investment opportunities can be identified.

Similar commitments to a growth-oriented stance can be seen in the UK, and this has led to lower borrowing costs (and reduced repayment pressures) for most of the



◀ EU member nations. These trends have carried-over to the creditor nations as well, with bond yields in these “safe haven” countries dropping below their appropriate levels (based on fundamental factors like fiscal position, monetary policy, and nominal GDP).

### Positive Effects of Austerity

If we look only at the news headlines, it would almost appear that austerity measures are a bad thing. Austerity requirements have been one of the root causes of political conflicts and loan negotiation disagreements as some suggest that economically troubled countries cannot bear the weight of national budget reductions. But the reality is that reduced government spending can (and should) be a good thing and if we look at the numbers, this has

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actually been the case.

Budget reforms and structured austerity plans have created additional breathing room for debt to rise without reaching levels that are unmanageable. This allows governments to maintain predictable fiscal policies, and in countries like Ireland (which began its tightening programs early on), the fiscal picture has already turned positive.

The trend in Greece is showing improvement as well. To aid the process, the IMF has proposed

plans for fiscal consolidation that are more modest and manageable. These reduced targets (in areas like the debt-to-GDP ratio) have been accompanied by creditor write-downs on Greek debt. So, while the EU and ECB are not willing to take a haircut on these assets, there is an increased likelihood they will accept lowered interest rates, extended maturities, and deferred interest payments - all of which help to ease the burden on the regions debt-troubled countries.

### Avoiding a Greek Exit

Thus far, Greece has managed to avoid a forced exit from the Eurozone but it is useful to look at the potential effects of a “worst case scenario” so that investors can best position themselves for whichever outcome is most likely. To be sure, we are seeing an improved consensus relative to political and economic reform but this does not remove the possibility that Greece will be unable to remain a part of what has already been called a fractured economic union. If popular unrest were to increase to the point where an exit did occur, the effects could be dramatic. In this worst case scenario, analyst projections suggest that GDP rates in the Eurozone could fall by as much as 5% for the year, and this would almost certainly be accompanied by extreme volatility in world stock markets.

So, the next question to ask is: What will it take to avoid a Greek exit and prevent chaos in trading markets? The answer could be seen in the results of the Italian and German elections. These two events will be key for understanding the level of popular support that rests behind recent initiatives enacted by policymakers as they look to keep the EU intact. If we see German voters select Angela Merkel for another



◀ term, this will be an implicit sign of approval that a popular majority is in favor of a cohesive European Union, and that this majority is willing to extend favorable lending terms to the region's indebted nations. Additionally, German officials might take this opportunity to install a regional banking union which would allow for common deposit insurance, resolution authority controls, and locational bank supervision.

### Potential Investments Opportunities: The Ireland Fund

Since most of the evidence supports the assertion that EU officials will do everything in their power to keep the union intact, investors should look for ways to capitalize on the recent sell-off in stock values. This means finding companies that are trading below their historical averages and one of the best ways to do this is through the New Ireland Fund, which trades on the NYSE under the ticker symbol IRL. Focusing primarily on Irish securities, the fund looks to build on a number of supportive factors which include the fact that Ireland is the only English-speaking member of the Eurozone that continues to be an attraction for Foreign Direct Investment (FDI).

This advantage comes with the country's wide pool of skilled labor and superior corporate tax rates, and all of these factors make Ireland an ideal location for multinationals looking to gain exposure to European markets. With net assets of over \$56 million, the New Ireland Fund is currently trading at an 11.5% discount to NAV and is looking to close that discount through unique strategy propositions and low volatility macro hedging. This allows the fund's managers to create a high-yield equity portfolio



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with limited downside risks in what otherwise might be considered to be an uncertain financial environment.

To do this, the New Ireland fund has embedded a number of filters as a means for identifying high quality companies. The ultimate goal here is to capitalize on the market's inaccurately low valuations and recent negative momentum in

order to find long term investment opportunities that can outperform its benchmark index as the wider global recovery continues to solidify.

### Portfolio Themes in the New Ireland Fund

In looking for a large turnaround in regional markets, the New Ireland Fund has positioned itself with high quality companies that are characterized by positive momentum (either in earnings-per-share or in total returns), strong cash flow, strong balance sheets, and the ability to outperform its peers and grow its market share in what might also be considered to be a newly Darwinian financial world.

Looking at the New Ireland Fund's portfolio themes and sector allocation, the first important area can be seen in its exposure to businesses with high-quality franchises. This essentially refers to Irish companies that have developed strong brands and performed well in domestic markets before expanding internationally. Some key examples include low-fare airline Ryanair, with its strong balance sheet and established reputation for stable practices, and Kerry Group, which is a high-quality manufacturer of food ingredients and flavorings that recently announced plans for a \$100 million research and development facility outside of Dublin. Paddy Power is another solid example, as the company is a rapidly growing sports betting unit that has shown a great deal of success with its brand development and franchising efforts.

The next main theme in the fund deals with the domestic angle, and looks to build on the prospects for a recovery within the Irish economy itself. Stock selections here include FBD, which is an Irish insurer that is another example of strong

◀ positioning and a stable balance sheet, and CPL Resources which is an employment agency that is likely to benefit from improved trends in the country's labor market. Bank of Ireland is another excellent selection in the fund's portfolio, as the company has recently restructured and recapitalized in order to meet the financing needs of the Irish economy.

The third main theme in the fund centers on a cyclical recovery strategy, and some of the highest quality names in this category include paper manufacturer Smurfit Kappa Group, insulation panel manufacturer Kingspan, and Grafton Group, which is a DIY retailer that focuses on the Irish and UK consumer markets. Kingspan relies heavily on green technologies in its operations, so this choice offers additional exposure as an energy efficiency play.

From a bottom-up valuation perspective, these selections offer attractive valuations and sound business models that are poised to perform well as markets move forward toward recovery. Stock markets have yet to fully price-in this recovery and this is creating the potential for attractive investment opportunities in high-quality companies using unique business models run by excellent management teams. The New Ireland Fund is actively managed to identify these opportunities and maintain a well-diversified portfolio that is positioned to capitalize on the strengths of Irish businesses and in the wider macro recovery story.

### **Outside Exposure with the Israel Fund**

When looking for other ways to invest in the longer term recovery, an attractive option for investors looking to gain exposure to the peripheral European markets can

be found in the Israel Fund, with its primary focus on Israeli securities and trades on the NYSE under the ticker symbol ISL. The Israel Fund looks at individual stocks selections as the main driver of returns, and the fund's picks are based on the identification of attractive sector stars with positive momentum and stable balance sheets.

Supportive factors for the Israeli economy can be seen from many different directions. While some argue that the country is limited in terms of natural resources, it should be remembered that two of the world's largest discoveries of natural gas were recently made off the coast of Israel. These discoveries will provide substantial benefits for Israel's economy and help to ensure its energy security in the long term. In addition to this, Israel is home to many high-tech companies, supported by an innovative entrepreneur base and a highly educated workforce. Israel is behind only the U.S. and China in the number of companies listed on Nasdaq, so Israel's position in the high-tech world is clear.

Apart from the IT sector, the Israel Fund offers diversified exposure to consumer-focused companies, and these positions are based on the idea that the potential for domestic demand growth in Israel is strong, given its young and growing population. From a wider perspective, these assertions are supported by the fact that Israel's economy has shown a high level of resiliency, as its economic damage from the global financial crisis was limited. This resiliency has been created largely by Israel's stable banking sector, prudent fiscal policies and sound macroeconomic fundamentals. Israel's GDP growth is expected to increase to nearly

4% this year and this scenario helps validate the portfolio selections that can be found in ISL.

### **Capitalizing on Europe's Stabilizing Recovery**

While it can be said that there are still risks present for the economic performance of the Eurozone in 2013, most market analysts are expecting this year to be one of gradual recovery and political cohesion. Most of the available evidence supports these projections, as economic data and central bank statements suggest that the worst is behind us and that market volatility will continue to ease. For investors willing to take a 5-year time horizon when establishing positions in European markets and the peripheral economies, significant opportunities can be seen. Two of the best examples of this can be found in the New Ireland Fund and the Israel Fund, which look emerging opportunities in some areas of the region that tend to receive fewer headlines in the financial media.

At this stage, most of the evidence suggests that longer term investments will be rewarded with superior returns as a bruised and battered asset class returns to its historical averages and re-emerges as an attractive value with strengthening fundamentals. 2013 will likely be viewed as a pivotal year for the Eurozone, as regional authorities grapple with sovereign and banking issues in need of continued reform. All of these factors, however, show an excellent entry point for gaining exposure to these markets. Regional stocks have not seen valuations this cheap since the early 1980s (based on price-to-earnings and price-to-book ratios) and this is a clear indication that the time is now to capitalize on these latest opportunities. ■