

European equities: Return of volatility could provide an entry point

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The recent reversal of bond and currency market trends has seen European equities come under pressure. We continue to see a variety of other factors that can offer support to share prices.



German 10-year bond yields hit 1.0% this week, their highest level since September last year. This represents a sharp upward move from the low of 0.05% reached in mid-April following the launch of the European Central Bank's (ECB) quantitative easing drive.

The rise in bond market volatility in recent weeks has caused some concern among investors and put pressure on eurozone equities. However, we would largely characterise the moves as a normalisation of the market environment. German government debt, as a safe haven asset, had been heavily in demand as investors feared economic weakness in the eurozone and the threat of deflation. That threat appears to have receded; preliminary data showed an annual inflation rate for the eurozone of 0.3% in May, up from 0.0% in April. Meanwhile, economic growth is slowly but surely picking up, with eurozone GDP growing by 0.4% in the first quarter of this year.

There may be another factor at play too in the rise in German bond yields, which is the looming possibility of a Greek default. The bulk of Greek debt is held by institutions and contagion effects should be limited. Nonetheless, should the long-mooted Grexit finally occur, market confidence is likely to be negatively affected for a period.

At the same time as the move up in bond yields, the euro has strengthened versus the dollar. Earlier in the year, the euro was pushed down by the ECB's actions and the expectation that the US economic recovery would see the Federal Reserve soon raise interest rates. Some recent lacklustre US data has called that assumption into question and the dollar has consequently weakened.

Low government bond yields and euro weakness had been two factors driving eurozone equity prices, so as these trends unwind it is little wonder that equities have experienced some pressure. However, they were by no means the only factors offering support to shares. The recovery of Europe's banking sector since last year's Asset Quality Review remains an important driver, with bank lending to corporates starting to pick up. We would expect this to accelerate further in the coming quarters as indicated by several credit surveys.

There have been positive signals from companies as well. The recent first quarter earnings season was a largely upbeat one for European companies. Sales and profits both saw improvements, with the stronger sales indicating that profitability gains were not due simply to cost cutting. Moreover, sales growth has not been driven solely by beneficial foreign exchange rates – many European companies have reported stronger organic growth as underlying demand has picked up.

We would further highlight that the expected boost to consumers from the drop in the oil price has not yet fully filtered through. Taken together, these factors should offer further support for eurozone equities and the volatility around the Greece predicament could well provide an attractive entry point.

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