Pan Europe update

Monthly commentary

August 2014

Market overview

Pan European equities fell in July. Sentiment was hurt by heightened geopolitical tensions in Ukraine and Israel's Gaza ground offensive, coupled with concerns that sanctions imposed on Russia for the alleged downing of a Malaysia Airlines jet could stall economic recovery. Risk aversion also rose on the back of contagion fears triggered by problems at Portugal's second largest lender, Banco Espirito Santo (BES).

On the economic front, industrial production declined in Germany, France and Italy, underscoring the Continent's still-fragile state of economic health. In Germany, investor confidence waned in July amid dampened growth prospects. Portugal's central bank, in response to the crisis, will inject 4.4 billion euros into BES to avert a bank run and stabilise the banking system. It also suspended three members from the Espirito Santo family that had founded and controlled the bank for generations.

Meanwhile, the Bank of England kept its key interest rates unchanged at a low of 0.5%. However, investors are expecting the central bank to normalise monetary policy soon, particularly if the economy continues to recover robustly and in light of June's increase in headline inflation. A preliminary estimate for second-quarter GDP showed that the British economy had surpassed its pre-crisis peak set in 2008. The economy expanded by 0.8%, the sixth straight quarter of growth, driven largely by the services sector.

The political focus was on the steady increase of sanctions on Russia. A ban on buying equity or bonds issued by state-owned banks was enforced along with cessation of exports of goods meant for Russian military use or unconventional oil production. In response Russia banned Western imports of food and agricultural goods.

Looking ahead, pan-European equities could face further volatility as various headwinds persist. Although the global economy is expected to post a modest recovery, growth is uneven. The US and the UK appear to be faring much better than their peers in the Continent and, as such, concerns over a hike in borrowing costs have surfaced. In comparison, more is being expected of the ECB in terms of unwinding the restrictive credit conditions that appear to be impeding a meaningful recovery. This appears particularly pressing, as Italy sinks back into recession, while Germany's industrial production has yet to pick up as quickly as was expected, and this could signal another few quarters of anaemic growth.

Model portfolio news (Pan Europe)

In July, we increased our exposure to speciality chemicals maker Croda, taking advantage of its more attractive valuation after recent weakness in its share price.

Note: Any changes refer to those of our model portfolio, which is the basis for actual portfolios we manage that have similar investment objectives. However, there might be minor variations, so the comments may not apply to all portfolios.

Corporate news

Basic Materials: **BHP Billiton**, amid a wide-reaching productivity drive that has already pared jobs elsewhere, will cut 163 jobs from its Mount Arthur coal mine in Australia. Chemicals producer **Croda** posted weak interim results mainly owing to sluggish European demand and adverse currency movements, even though growth in new products and Asia proved mitigating factors. Although disappointed, we are confident of its long-term investment case.

Consumer: **British American Tobacco** reported good sales and profits on the back of price hikes, better sales in emerging markets, and efficiency gains. **Casino** will buy Coopérateurs de Normandie-Picardie and Mutant Distribution's 63 convenience stores to extend its network in Normandy. Its second-quarter results benefited from higher organic sales growth. **Tesco** will build 4,000 homes in the UK on sites previously earmarked for supermarkets. This would allow it to liquidate some property assets and possibly help ease the domestic housing shortage. Watch-maker **Swatch** posted decent sales, both organically and from the Harry Winston acquisition, but earnings were pared by adverse currency movements and higher marketing expenses. The prospect of new 'smart' watches from rivals, such as Apple and Samsung, weighed on its share price as well.

Financials: **Nordea Bank**'s net interest income was flat, while restructuring costs elevated operating expenses. Its core capital ratio, however, improved and it may raise its dividend payout. The lender expects a third-quarter gain of 2.8 billion kroner from the sale of its 20.7% stake in Danish group Nets Holding. As part of its strategy to prune underperforming units, **Zurich Insurance Group** will sell its Russian retail unit for US$30 million. Although this will incur US$300 million in estimated losses, the impact on shareholder equity is minimal.

Healthcare: **GlaxoSmithKline**'s softer performance was due to pricing pressure in the US, competition in the generics segment and supply issues in the consumer healthcare division. Management now expects flat earnings this year, but is confident about its medium-term prospects from new product launches, divestments and upcoming deals. In particular, the drugmaker will buy Novartis' vaccines business and sell its oncology portfolio to the firm.

Industrials: **Assa Abloy** acquired the ENOX brand's locks and hardware business from India's Pooja Hardware, which will complement its existing business there. The lockmaker posted steady sales, with improved demand in Europe and Asia Pacific offsetting weaker contribution from global technologies. It maintained its strategy of reducing its exposure to mature markets in favour of emerging ones. **Atlas Copco** noted that demand stabilised after previous weakness, while recent acquisitions boosted total turnover in the latest quarter. **Experian** experienced subdued trading, especially in Brazil because of the World Cup, but expects second-half revenues to drive full-year earnings growth. Separately, Norwegian defence and maritime specialist **Kongsberg Gruppen** announced several orders, which included a lucrative government contract to develop a fighter-jet missile system. **Schindler** acquired majority control of its Chinese joint venture, Henan-based XJ-Schindler Elevator Co, which is likely to generate at least 300 million Swiss francs in revenue this year.

Oil & gas: **Royal Dutch Shell** reported healthy results, with good cashflow delivery. Its second-quarter earnings more than doubled from a year ago, benefiting from improved production of liquid petroleum and higher prices for some products. However, it booked sizeable asset impairments, largely related to US shale assets.

Technology: **Ericsson**'s sales and profits beat estimates, aided by China and the Middle East.

Utilities: **Centrica** agreed to sell 80% of its stake in each of its two Trinidad gas blocks for US$23 million. **GDF Suez**'s interim operating profits fell because of lacklustre European demand for electricity, the mild winter and stoppage at two of its Belgian nuclear reactors. Nevertheless, the company stood by its full-year profit forecast.

We hold the companies highlighted above.

Performance of European stockmarkets

Region/country	Index/fund	USD dollars			Local currency		
		MOM	3M	YTD	MOM	3M	YTD
UK	FTSE Allshare	-1.56%	-0.12%	3.40%	-0.29%	-0.19%	1.45%
UK	FTSE 100	-1.38%	0.10%	3.91%	-0.11%	0.03%	1.95%
UK	FTSE 250	-2.51%	-1.22%	0.74%	-1.26%	-1.29%	-1.16%
UK	FTSE Small Cap	-1.79%	-0.57%	2.99%	-0.52%	-0.64%	1.04%
UK	FTSE 350 Real Estate	0.02%	1.35%	11.60%	1.30%	1.28%	9.49%
Europe	FTSE Europe	-3.77%	-2.72%	2.01%	-1.79%	-0.27%	3.55%
Europe	FTSE Europe ex UK	-4.88%	-4.01%	1.27%	-2.57%	-0.44%	4.43%
Denmark	Denmark - OMX Copenhagen 20 Index	-2.71%	1.23%	18.20%	-0.48%	4.75%	21.81%
Finland	Finland - OMX Helsinki 25 Index	-1.98%	0.08%	4.84%	0.25%	3.67%	8.09%
France	France - CAC 40	-6.10%	-6.87%	-1.64%	-3.96%	-3.52%	1.33%
Germany	Germany - DAX	-6.46%	-5.44%	-4.48%	-4.33%	-2.04%	-1.51%
Ireland	Ireland - ISEQ Overall Index	-3.31%	-8.32%	0.31%	-1.11%	-5.03%	3.33%
Italy	Italy - FTSE MIB Index	-5.53%	-7.13%	7.20%	-3.35%	-3.73%	10.69%
Netherlands	Netherlands - AEX	-4.32%	-1.43%	-0.43%	-2.14%	2.12%	2.57%
Norway	Norway - OBX	-3.94%	-0.29%	7.12%	-1.44%	5.51%	10.97%
Portugal	Portugal - PSI 20	-14.05%	-20.88%	-9.48%	-12.09%	-18.03%	-6.74%
Spain	Spain - IBEX	-3.23%	0.80%	8.41%	-1.03%	4.42%	11.68%
Sweden	Sweden- OMX Stockholm 30 Index	-2.80%	-4.20%	-0.11%	0.22%	1.61%	7.34%
Swiss	Swiss - SMI	-4.04%	-3.77%	2.25%	-1.69%	-0.65%	4.72%
World	MSCI AC World	-1.18%	2.95%	5.24%	-0.34%	3.61%	5.35%
World	Citigroup World Government Bond	-0.94%	0.21%	4.01%	-0.94%	0.21%	4.01%

Source: Bloomberg
Note: Total indices performance table for the month ended 31 July 2014

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