

Outlook for Europe in 2012

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Sam Morse, Portfolio Manager, Fidelity European Fund



"2011 has been an unpredictable, if not erratic, year for European equity investors. Unfortunately, I do not foresee this pattern changing as we enter 2012. Question marks over the Euro, the sovereign debt crisis and slow economic growth will all continue to dominate the headlines and investor behaviour. Crisis, however, can bring opportunity too: I have been able to find consistent dividend growers at cheap valuations, that will, I believe, serve my investors well in 2012 and beyond.

My base case scenario for Europe remains the same, although my confidence in this has reduced. I think that all nations within the Eurozone will strive to keep the euro together because the pain of leaving the euro will be too high, both financially and politically, both for countries leaving and those remaining.

If a country were to leave the Eurozone, its citizens will experience a dramatic decline in wealth and buying power. Imports of food, fuel and pharmaceuticals are essential to the well-being of people in countries like Greece and Italy. Leaving the Eurozone would reduce the affordability of these goods because prices would automatically inflate as an inevitable consequence of a devalued Drachma or Lira. Furthermore, individuals and companies that owe money on euro loans will see their debts jump, overnight, in size. The technical and legal costs will be massive because when joining the euro no-one planned or expected that they would leave again: there is no exit play-book. There is also a crucial political angle that must be considered by those countries mulling a Eurozone exit – under current treaty rules they would also have to leave the European Union and lose all the benefits that entails. Austerity measures have created much distress, especially in those countries worst affected, but the pain of austerity will seem bearable compared to the pain of exiting the euro – it is the lesser of two evils.

If a country were to leave the Eurozone, considerable pain would be inflicted on those countries that remain. Contagion fears would be the first effect – if one leaves who will be next? Given the loss of wealth for a country that exits, there will be a significant negative impact on any companies that export to that country and also on any financial institutions that have lent money to that country. Needless to say, the other Eurozone members would feel the effect of a fellow member's exit more than other nations.

So what can be done? We have seen a few (so far unsuccessful and disjointed) attempts by policy makers to stem the current problems, but there are a few, more extreme, measures that can be taken. For example, anything that boosts growth in the euro area as a whole would make spending cuts in the south easier to absorb. Quantitative easing – or printing money – is an option that has been taken in the US and UK but not so far in Europe (due to long German memories of the hyper-inflation of the Weimar Republic). We have seen a sterilised form of QE, but policy makers could print money (unsterilised) to weaken the euro and buy time in the hope that global economic growth will improve.

Political change is sweeping across Southern Europe which could herald new governments that are more willing to take radical action in terms of reform, privatisations and other measures. Ultimately, Germany and other nations could agree to guarantee the debts of weaker countries, if they are satisfied that those weaker nations are taking appropriate steps towards structural reform.

From an investment point of view the key question for me is: what to do now? I always look at company fundamentals and try to find attractively valued companies that will be able to grow their dividends in good times and bad times. I think this strategy will continue to deliver relative strength, even if a Eurozone break-up becomes more likely. If there is a break-up, there will be direct and indirect effects on nearly all European companies so it is essential that we ‘turn the stones’ to assess what will happen to each company in different scenarios. As I have said, my base case remains that the Eurozone will survive, but I must be prepared, even for a potential break-up, and understand and anticipate the likely effect on each company, whether held in the portfolio or not. In the event of a break-up, the market is likely to be volatile and weak, but there will be relative winners and losers. As always, good stock picking will be crucial.”



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