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INVESTMENT NOTE **13 JANUARY 2014**

Selectivity still the key for 2014, says Andrew Parry, CEO, Hermes Sourcecap

“Markets and economies should muddle along in Europe, but the real story will be finding the individual company winners in a slightly more benign world.

“European economic data continues to be varied, with enough good and bad statistics to keep both the bulls and bears happy. The latest Markit Purchasing Managers’ Index for services in Spain signalled a sharp upturn in activity, and the pace of job losses there also eased. However, at the same time survey data for France was poor and the UK services PMI data also disappointed, albeit that it was coming off its highest ever recorded level in October.

“These mixed messages illustrate why it is dangerous to take a blanket view of “recovery” in the region. With PE ratios for Europe at close to ten-year highs, there has been a significant rerating of stocks over the last 18 months that has not been backed yet by an actual recovery in profits. Indeed, virtually the entire market movement in 2013 came from a rerating of stock prices, not from earnings growth. While the normalised PE on the European market looks reasonable, a significant proportion of the all elusive rebound in company earnings has been discounted already. The good news is that the stronger companies in the region have gained market share in recent years, maintained high profit margins and are well financed so that they are geared to any recovery in demand.

“There are tentative signs of a recovery in the confidence of company management and hints of increased investment intentions, though that runs in parallel with growing interest in M&A activity. Investment spending has been a key missing element in the recovery. Thus far, higher business confidence has not led to increased fixed capital formation and so these putative signs of it being translated into actual spending intentions for 2014 on new productive assets are encouraging. However, time will tell if the good intentions are followed through or if companies prefer the easier, short-term options of share buy-backs and M&A activity. Loose monetary conditions certainly encourage the latter two policies.

"The IT sector has seen some increase in corporate spending, which reflects the rapid development of processing power and the new, labour saving applications that these spawn. The maintenance of high corporate profit margins through the global downturn is in part down to the increased use of technology, which has allowed companies to become leaner and more efficient. Over the next five years or so we can expect to see significant developments in a whole range of industries driven by the introduction of new technologies and escalating processing power. There will be undoubted losers from these changes, but the creative destruction cycle will also lead to significant new businesses and industry opportunities. It is for this reason that we remain overweight in technology shares.

"Last year's optimism may continue this year, especially as the European economy will expand, but the emphasis will inevitably switch to where the growth is being delivered at the corporate level rather than a blanket buying of risk that we saw at times in 2013. We are encouraged that there is a greater availability of good stock ideas as more companies show signs of expansion, but valuations are already discounting much of that growth, so selectivity is essential."

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