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MARKETS

Investors Search for Opportunity in Unloved Corner of Stock Market

European shares have recovered this year, but investors remain pessimistic and wade in gingerly

By Avantika Chilkoti

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European stocks have been among the least liked investments for fund managers in recent months. Yet some investors, sensing Europe's economic gloom lifting, are gingerly returning to the region.

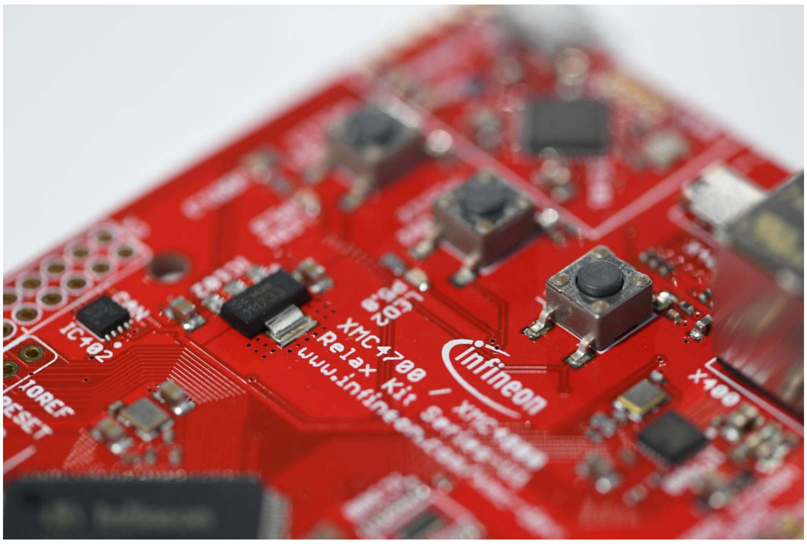
European shares have rebounded strongly so far this year, with the benchmark Stoxx Europe 600 up 16%. That slightly lags behind broad markets in the U.S., where the S&P 500 is up 17%. While U.S. indexes hit record levels last week, European stocks are still some way off the highs reached four years ago, and there remains skepticism that the region's stocks will have what it takes to pull ahead.

Investors are so generally pessimistic about European stocks that it creates an opportunity because the "news flow doesn't have to be that positive for people to start buying," says Emiel van den Heiligenberg, head of asset allocation at Legal & General Investment Management.

He expects the regional economy to stabilize or recover in coming months as countries roll out more generous fiscal policies. His group has been buying European benchmark indexes while trimming its heavy bets on the U.S. But it also has been adding extra exposure to the basic-resources sector in Europe, which is less reliant on growth in the region itself.

"That's a European sector, but the main play there is on China," said Mr. van den Heiligenberg, who expects a recovery in the Chinese economy following a series of generous fiscal policies.

Europe has been dragged down by the political uncertainty around Brexit, government finances in Italy and weak German growth. Talk of tariffs on exports into the U.S. also has weighed on investors. The mood worsened after the European Central Bank slashed forecasts for growth in early March.



An Infineon microcontroller kit XMC 4700. One mark against European stocks: The region lacks a large base of technology companies. PHOTO: ANDREAS GEBERT/REUTERS

Reflecting those concerns, the yield on 10-year German government bonds are again in negative territory, reaching minus-0.019% on Friday.

The euro has slipped to a 22-month low against the U.S. dollar, which suppresses returns for U.S.-dollar-based investors but also helps Europe's export-oriented companies be more competitive.

U.K. and eurozone stocks are the assets that investors are the most negative about compared with their past views, according to Bank of America Merrill Lynch's latest Global Fund Manager Survey, which covers 239 panelists who control a total $664 billion in assets. European equity funds have faced net withdrawals in all but two weeks over the past year, according to fund-flow data provider EPFR.

One mark against European stocks is that the region lacks a large base of technology companies, a sector that has pulled U.S. stock markets higher, on the backs of companies such as Facebook Inc., Apple Inc., Amazon.com Inc., Netflix Inc. and Alphabet Inc.

Tim Crockford, lead manager for Europe outside the U.K. at Hermes Investment Management, points to companies such as Kion Group AG, a German forklift producer, which could benefit from the shift to automation in large warehouses as e-commerce groups expand.

"Europe does have some very exciting tech companies; it's just that they tend to be somewhere in the middle of the value chain rather than the very downstream or at the top end," Mr. Crockford said.

Some bullish investors see reasonable valuations on businesses with a global market rather than in an improvement in the regional economy itself.

Benjamin Segal, portfolio manager at Neuberger Berman in New York, has been building a position in Kerry Group PLC, an Irish butter maker with a large presence in emerging markets and North America; Infineon Technologies AG, a German semiconductor maker, and Gerresheimer AG , a German packaging producer supplying global drugmakers, among others.

“I’m not calling the bottom because I’m not smart enough to do that and I have got it wrong too many times,” Mr. Segal said, adding that some sectors such as health care, pharmaceuticals and consumer staples are still looking relatively expensive.

Investors have repeatedly been burned taking an optimistic view on Europe’s economy. Some piled in too early, buying up European equities at the end of 2017, amid growing optimism around the election of French President Emmanuel Macron, who promised to push through major economic reforms, many of which have been stymied.

Despite joining global markets in a sharp recovery so far in 2019, Europe started from a lower base, having done much worse than other developed markets at the end of last year.

The valuations of European and U.S. equities have diverged since the end of 2016 on certain measures. The Stoxx Europe 600 is currently trading at 14 times forecast earnings, compared with 17 times for the S&P 500, according to FactSet data. The gap in those ratios remains substantially wider than its long-term average over the past decade.

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