MLC Viewpoint

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Observations from Europe on recent market volatility

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I've spent the last week in Europe, meeting fund managers and hearing their views on the current volatility in global markets and the outlook. Here are some of my observations.

The political background in Europe

Markets hate uncertainty and the recent global market volatility bears that out. There are a number of issues that markets are looking for clarity on. In Europe, another round of elections in Greece, and parliamentary elections in France, will mean anti-austerity rhetoric will rise. In France, President Hollande will need to maintain an anti-austerity or pro-growth stance into the June elections to ensure that the centre left not only secures the presidency but also control of parliament. Markets are likely to take fright from the anti-austerity comments in these countries. However, the head of the leftist party in Greece has recently toned down his language, which may suggest a compromise on some of the most extreme positions.

Fears of runs on banks

Matters in Europe haven't been helped by reports of deposit flight in some European banks. It's impossible to know how accurate these reports are (and in London this week I've heard some strong rebuttals) but the market is likely to "act first and ask questions later". These reports have added to the market uncertainty.

A Greek exit?

The fund managers I've met have expressed a range of views on whether Greece will leave the euro. They're well aware of the risks of contagion to other eurozone countries and the possible impact on the global financial system. There's a widespread belief that a Greek exit would result in the European Central Bank issuing eurobonds, which might go some way to shoring up the market.

European shares are undervalued

What's been particularly interesting is that European fund managers are looking very hard at European companies and adding to holdings or buying into new positions. While this isn't a huge shift, it's very noticeable. The rationale is that valuations are low and the shares are therefore cheap. One manager put it simply: by most valuation standards, European stocks are back to pre-1996 levels. The current valuations for some large European companies suggest they won't grow for the next 10 years, which some managers consider too pessimistic.

Green shoots in the US

Elsewhere, also contributing to market uncertainty is the US's year-end "fiscal cliff" – the automatic federal spending cuts and tax increases that could seriously affect its economic recovery. In an election year, the rhetoric about these fiscal issues is likely to be loud and very partisan, especially in the run-up to the party conventions in August and September.

However, I think there are reasons to believe that the US housing market is now stabilising, after five years of misery (the market actually started falling in 2007). This will remove a significant drag on US GDP, and a gradual recovery in the housing market could really benefit growth there. In the last four to five weeks, some of our global managers have been buying housing-related stocks, such as Home Depot and paint company Sherwin Williams.

Slowing growth in China

Questions about the strength of China's economy are adding to the uncertainty that markets are dealing with. There's no doubt that China's GDP is falling, and this is happening at a time of some political turmoil in domestic Chinese politics. I have two observations on this. First, historic changes in the political guard in China have very rarely been smooth. The last major transition in 2005 was a major exception and I think markets mistakenly see that as the norm. Second, China is at the start of a new five year plan. It's very likely that the first year of a plan will see lower growth, after feverish growth the previous year to ensure plans are completed on time.

It's difficult to verify this because China has been in such a strong growth phase recently that historic analysis may be misleading. However, I think markets will miss the subtleties of both points and simply fret about growth.

Healthy corporate balance sheets

Although many governments are debt-ridden, there are many companies worldwide with finances in good shape. They have falling debt levels, plenty of cash, attractive valuations and many of those that aren't exposed to Europe have growing sales and expanding profit margins. So when you look at these fundamentals, the picture for companies is by no means all doom and gloom.

The outlook

As always, it's very difficult to know how long this period of uncertainty will last and there are many factors to keep markets worried and journalists busy. However, MLC's managers believe that share valuations are already factoring in that uncertainty and that in this environment, good businesses will not only survive but thrive. Volatility in markets throws up as many opportunities as threats and in these circumstances, good stock selection by skilled active managers is key.