Are we heading for a Europe-led correction?

Investors should lower exposure to Europe

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A shock profit alert from EasyJet and increasing political uncertainty ahead of European elections next month have heightened the risk of significant underperformance by European equities this year.

Earlier this month the low-cost airline blamed Brexit as well as wider macroeconomic uncertainty for weakening passenger demand and lower ticket yields across Europe. The news followed a recent spate of worse-than-expected economic data from Europe and its largest economy, Germany, where the manufacturing sector contracted at the fastest rate in more than six years.

Should investors care about European equities?

Both developments reinforce the risks of an impending recession throughout the region just as the political clouds darken. The recent six-month extension granted to the UK to sort out its Brexit position, together with growing anti-EU protests in several countries including France, Netherlands and Italy in the run up to elections for the European parliament on 23 May, look set to sour investor sentiment further.

Soon after the elections are over, Europe will be heading into its seasonal holiday slowdown. Put together all these factors and you have a recipe for increased volatility in financial markets and a big correction, possibly led by Europe but extending out globally.

We are particularly negative on continental Europe due to long-term structural weaknesses including an aging population, high unemployment, persistently low economic growth and high sovereign debt in some of its major economies.

For example, debt as a percentage of GDP in Greece amounted to 186% in 2017, according to official European Commission data (Eurostat). In Italy it was 131% followed by France and Spain at almost 100%. Added to that is the European Central Bank's (ECB's) own debt pile, which has mushroomed due to its large quantitative easing programme over the past ten years to stave off an economic slump in the wake of 2008's Global Financial Crisis.

Fifth month of outflows for retail funds as investors shun UK and European equities

It is worth comparing this to the UK's debt, which amounts to around 87% of GDP. I also believe the UK is better positioned for the long term, with lower unemployment, and domestic equities on a value discount, with a prospective earnings multiple of 13 and a yield of 4.75%. In contrast, the Eurostoxx 600 index is priced at more than 14 times this year's forecast earnings and a prospective yield of about 3.8%. A possible decline by the euro could pose a further risk to owning European assets.

As a result, investors should lower their exposure to continental European markets, in particular the banking, industrial and manufacturing sectors equities. In contrast the UK market looks better value, with a particular bias towards defensive UK equities offering above average yields. Some UK stocks we like include Legal & General, Royal Dutch Shell, Standard Life and Vodafone. The fund also owns some Swiss based blue-chips including Roche, the drugs giant.

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