Europe: Back to Business

July 30, 2015

After a contentious period of negotiations, the odds of a so-called "Grexit," or Greek exit from the euro, were drastically reduced as Greece begrudgingly accepted an austerity program and Germany gave the European Stability Mechanism the green light to negotiate a third bailout. While Greece's troubles are far from over, Philippe Brugere-Trelat, executive vice president and portfolio manager for Franklin Mutual Series®, says it's important not to lose sight of the fact that in much of Europe, the story is one of economic recovery—not collapse. He's back to the business of finding values for his portfolios there.

It is important to keep in mind that Greece's role in the European economy is very small, almost negligible. Before the European sovereign debt crisis starting in 2010, Greece's economy represented about 2% of the eurozone's gross domestic product (GDP); after the crisis-induced recession, it accounts for even less. In my view, Greece could really be considered a rounding error in terms of trade and exports and GDP contribution to Europe and the world at large.

From a financial standpoint, the impact is also very limited because most, if not all, of the debt Greece owes is held by public and governmental entities: the International Monetary Fund, the European Union and the European Central Bank (ECB). I think what shook markets across the globe was not the size of Greece's economy or financial system, but more the prospect of a Greek exit from the eurozone, which would have put a big question mark over the irreversibility of the entire euro system. The main, very positive consequence of the Greek rescue agreement—even if nobody in Greece or in the eurozone at large seems to like it—is that Greece appears to be staying in the eurozone and the construct has been safeguarded. A Greek exit would have left questions about the survival of the euro, likely leading to the widening of credit spreads in the periphery, or at least in Italy, Portugal and Spain. It also could have led to a rise in the equity risk premium demanded by investors in European stocks.

The vote by Greece's Parliament last week paved the way for bridge financing to tide Greece over while negotiations for a more permanent bailout are being held. There is a question in my mind about the political future of Greek Prime Minister Alexis Tsipras. In my opinion, he has completely destroyed any trust that existed between Greece and the rest of the eurozone. He had to rely on the support of opposition parties outside his government to get the austerity agreement approved, which raises the question of whether he is the right person to execute reforms he campaigned against.

Markets in Europe Relatively Calm amid Greek Storms

European credit and equity markets were relatively stable during the Greek crisis. In my view, that's mainly because economic data in the eurozone continued to be positive. Now that the specter of the Greek exit has been removed, I think we should see even more improvement. In our view, a favorable combination of four factors should help drive the eurozone economy much higher:

- The weakness in the euro, which helps exports of goods and services produced in Europe
- Low oil prices, which have a positive impact on input costs for a large number of European companies
- The significant and continuing injection of liquidity under the European Central Bank's

(ECB's) quantitative easing (QE) program
- An anticipated resumption of bank lending

The debt crisis in Europe was caused and accentuated by a total lack of lending, particularly to companies in the periphery countries. During the last six months, we have seen the situation reverse. We have seen a relaxation of lending standards; the cost of lending has come down. And, we have seen an increase in the supply of loans and an equal increase in the demand for loans from corporations for fixed investment purposes. I think those developments are very positive, and they are reflected in the fact that corporate earnings in Europe are being revised upward for the first time in many years.

Is There Value Left in Europe?

European equities are not that cheap anymore by a number of valuation metrics; they are trading at an average of about 17 times earnings, which is not a wide undervaluation.[1] In my view, the main reason to invest in European equities is the potential for, or the expectation of, a rise in corporate earnings that would be driven by the improving economic environment. As value investors, we believe it's always better to buy when things are just starting to turn the corner. I also think it would be judicious for investors to consider protection from potential euro weakness, particularly at a time when interest rates in the United States seem likely to rise and the ECB's QE program is underway and might even be accelerated if need be. Therefore, I don't see a great positive momentum in favor of the euro.

As far as sectors go, we like industrials in the broad sense of the word, including automotive suppliers, retail and everything that constitutes the backbone of the European economy. We also like telecoms because the regulatory environment is getting more benign for the sector; there is a clear movement of consolidation within countries and across borders, which I think could benefit a number of stocks. And, we favor European banks because we think banks will be the main beneficiaries of the resumption in corporate lending we anticipate. Bank earnings are driven by lending, and banks in Europe are still trading at what we think are good valuations.

One specific example of how we look to unlock value is Enel, a multi-national power company that is the largest provider of electricity in Italy.[2] Its Spanish subsidiary, Endesa, is the largest operator in the Iberian region, and the company also has a particular focus on Latin America. The Italian government holds the largest stake in Enel, and it is trading at what we think is an unreasonable discount to the European utility sector.[3] The company has a new CEO, nominated by Italy's Prime Minister Matteo Renzi, who has been given a mandate to clean up the corporate structure, drive down costs and drive up earnings. The CEO has communicated a strategy to grow earnings above the sector average. There's also a very strong cost-cutting drive at the company as well as an effort to refinance more expensive loans, which will lower the company's financial expenses. I think what we have within Enel is a very attractive, large, regulated asset base, which to me is largely undervalued by the market.

Philippe Brugere-Trelat's comments, opinions and analyses are for informational purposes only and should not be considered individual investment advice or recommendations to invest in any security or to adopt any investment strategy. Because market and economic conditions are subject to rapid change, comments, opinions and analyses are rendered as of the date of the posting and may change without notice. The material is not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy.

This information is intended for US residents only.

To get insights from Franklin Templeton Investments delivered to your inbox, subscribe to the Beyond Bulls & Bears blog.

For timely investing tidbits, follow us on Twitter @FTI_US and on LinkedIn.

What Are the Risks?

Franklin Mutual European Fund

All investments involve risk, including possible loss of principal. Value securities may not increase in price as anticipated or may decline further in value. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Because the fund invests its assets primarily in companies in a specific region, it is subject to greater risks of adverse developments in that region and/or the surrounding areas than a fund that is more broadly diversified geographically. Political, social or economic disruptions in the region, even in countries in which the fund is not invested, may adversely affect the value of securities held by the fund. The fund's investments in smaller-company stocks carry an increased risk of price fluctuations, especially over the short term. The fund's investments in companies engaged in mergers, reorganizations or liquidations also involve special risks as pending deals may not be completed on time or on favorable terms. These and other risk considerations are discussed in the fund's prospectus.

Franklin Mutual Global Discovery Fund

All investments involve risk, including possible loss of principal. Value securities may not increase in price as anticipated or may decline further in value. The fund's investments in foreign securities may involve certain risks, including currency fluctuations, and economic and political uncertainties. Smaller-company stocks have exhibited greater price volatility than larger-company stocks, particularly over the short term. The fund's investments in companies engaged in mergers, reorganizations or liquidations also involve special risks as pending deals may not be completed on time or on favorable terms. The fund may invest in lower-rated bonds, which entail higher credit risk. Please consult the prospectus for a more detailed description of the fund's risks.

Investors should carefully consider a fund's investment goals, risks, sales charges and expenses before investing. To obtain a summary prospectus and/or prospectus, which contains this and other information, talk to your financial advisor, call us at (800) DIAL BEN®/342-5236 or visit franklintempleton.com. Please carefully read a prospectus before you invest or send money.

——————————————————————————

1. Source: MSCI Europe Index, as of June 30, 2015. Indexes are unmanaged and one cannot directly invest in an index. See www.franklintempletondatasources.com for additional data provider information. The price-to-earnings (P/E) ratio is the current market price of a company share divided by the earnings per share of the company.

2. Source: Enel, July 2015.

3. Enel SPA represents 0.49% of total net assets of Franklin Mutual Global Discovery Fund and 1.99% of Franklin Mutual European Fund, as of March 31, 2015. Holdings subject to change.

Posted in Equity Tagged Franklin Mutual Series, Franklin Templeton funds in Europe, grexit, investing in europe, market outlook for europe, Mutual European Fund, mutual global discovery fund, philippe brugere-trelat

Data from third party sources may have been used in the preparation of this material and Franklin Templeton Investments ("FTI") has not independently verified, validated or audited such data. FTI accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments, opinions and analyses in the material is at the sole discretion of the user.

Franklin Templeton Distributors, Inc.