COLUMBIA THREADNEEDLE INVESTMENTS

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Philip Dicken,
Head of European Equities

What has happened in the first half of the year in your area?

Two things: first, political risk has bubbled up again. Although it never completely disappeared, domestic politics was not disruptive in 2017 – election results turned out to be market-friendly in France, Germany and even the UK. But this year Italy changed that. Yes, a government has been formed, which is good, but it is not entirely clear what follows. The resulting coalition gave the market a fright, but it doesn't seem to have created lasting problems.

Second, in terms of performance, earnings growth looks reasonable for the year – more than 10% – but investment performance has varied sector by sector. Banks, for example, have underperformed while technology has stormed ahead. Our returns are ahead of the index, but the leadership has come from unexpected areas.

What was expected and what surprised you in the first six months?

We knew Italy was a risk, but we did not reckon with a Five Star/League coalition. However, this has not produced too much market turmoil. It has always been difficult to implement change in Italy, regardless of who is in charge, and given the two ruling parties come from opposite extremes (left-wingers from the south versus right-wingers from the north), this is not going to change anytime soon. Maybe this strange coalition of opposites will prove powerless?

Even the unflappable Angela Merkel has had problems with the German coalition; hardly had it been formed before it was under pressure over immigration.

Trade war threats have been worse than expected. Perhaps the surprise here is that it is actually happening. Disputes and haggling were always a risk, but most people thought President Trump was just sabre-rattling. Now we are confronted with real tariffs being introduced.

What do you expect to happen in your area in the next six months?

We remain quite positive, and European equities (excluding the UK) remain in favour with our asset allocation team: the market looks reasonable value, although not especially cheap, and economic and earnings growth is evident. We are mindful of valuations however, with some of our best companies beginning to look expensive, while those facing more challenges have got cheaper.

So, the question we face is whether this widening of valuation differentials is justified or sustainable? We are not changing our views dramatically, but valuation arguments have become more critical.

What are the key opportunities and challenges for investors in the second half of the year?

In terms of challenges, we have to weigh valuations against macroeconomic events: Brexit, trade wars and China's slowdown are just a few examples. If a stock's valuation gives us downside protection (ie, more of a margin for error), the share price could absorb one or two of those events without taking a knock. But if it is already overvalued then outside factors could cause share price weakness and a de-rating.

The biggest risk is not necessarily from poor companies that are struggling, because that might already be reflected in the share price. Rather, the danger is of complacency if a company with great performance has become too expensive – if there is no downside protection in the valuation it could get hit by macroeconomic events, and then the position is a hindrance to client returns. That is the challenge.

That said, we do not fear volatility. It may create unease among clients, but for long-term investors it creates opportunities – unwarranted share price weakness can give us an entry point.

Broadly speaking, global growth is encouraging, as is European growth. Earnings are pretty robust and valuations are reasonable – on top of which we need to keep expectations under control. So if things turn out better than we expect, it will be good for the market. But if in the short term things are worse, that creates a buying opportunity.

Whereas the US is late-cycle, Europe is not. The recovery was stifled by the eurozone crisis, and the repair work in the banking sector was not as quick or as comprehensive. As a result, Europe has lagged the US, and interest rates will not rise this year, so we may have less late-cycle disruption to worry about, though developments in the US may have an impact.

We like to buy great companies at a good price, but at the moment there aren't too many out there. Having enjoyed the FIFA World Cup in Russia this summer, perhaps a proverb from that country is in order: "Бесплатный сыр бывает только в мышеловке", which translates as "Free cheese can be found only in a mousetrap". There are great opportunities around, but don't forget the risks!

From the global financial crash in 2009 through to 2016, returns came from a rerating of the index, not earnings growth. It is only last year and this that we are finally seeing earnings growth, which is a much healthier development. As a result, we remain cautiously optimistic.

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