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The bull case for European equities

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European equities are not an obvious buy for US investors, who see their own economy forging ahead, corporate earnings beating expectations and a stronger dollar.

Yet with company earnings for the eurozone not as bad as expected, some believe the sector is now undervalued, creating pockets of opportunity in the continent.

Analysts at Barclays believe European equities could rally "significantly" if the European Central Bank embarks on full-blown quantitative easing, which they believe is not yet priced into stocks. They predict European markets, not including the UK, will grow at the most rapid rate of any other major market next year with a total return of 18 per cent, compared twith just 5 per cent in the US and 9 per cent for global and emerging markets.

Jack Ablin, chief investment officer at BMO private bank, is optimistic QE can help the eurozone.

"QE was effective in the US and if we see the ECB act, that should be cause for optimism," he says, estimating that developed world equities trade at a 25 per cent discount to the US market.

Yet the big problem for US-based investors is the dollar. The euro has fallen 9 per cent against the US currency since July – a trend that analysts are overwhelmingly forecasting will continue, as the Federal Reserve tightens interest rates next year while the European Central Bank talks of easing monetary policy further.

US and European shares jointly enjoyed a bull run in the first half of this year, but started to decouple in early summer when fears of deflation hit the eurozone. The S&P 500 has risen 15 per cent over the past year, while the MSCI EMU Index is up 3 per cent in absolute terms – but down 4 per cent in dollar terms.

Some US investors are hedging the currency exposure. Alan Ruskin, an analyst at Deutsche Bank, says fund managers that do hedge are doing so more than usual when buying European equities. Dale Winner, manager of the Wells Fargo International Equity Fund, hedges the currency risk for part of his portfolio and has been adding to European industrials he thinks will benefit from the falling euro – in particular companies that are cutting costs and trading cheaply such as Germany's Siemens, Holland's Akzo Nobel and Italy's Prysmian.

Others are buying products that take the currency risk out of the equation. The most popular exchange traded funds this year include the WisdomTree Europe Hedged Equity, which saw some of its largest daily net inflows in November, according to data from ETF.com.

Some believe European equities have further to rise than the euro has to fall, making them still worth buying even without a hedge. A rule of thumb investors use is that a 10 per cent fall in the euro against the dollar boosts earnings per share for European companies by 10 per cent.

T Rowe Price's head of equity, Bill Stromberg, told investors last week that while the world was "very bearish" on Europe, companies had been cutting costs to put themselves in a good position to outperform if earnings surprised on the upside.

"If there's a whiff of GDP growth we think you'll see really good earnings growth in Europe that could surprise on the upside, and stocks are cheaper there, so we would own some Europe as a really good hedge for some potential good news," he said.

The current European reporting season has been reasonably upbeat, with third-quarter earnings expected to be 12.1 per cent higher than a year ago, despite only a marginal 0.3 per cent increase in revenue over the same period.

Shares in European telecoms groups such as Vodafone, Deutsche Telekom, France's Orange and Telecom Italia have responded well to an unexpectedly strong run of results, while car manufacturers such as Volkswagen and PSA Peugeot Citroën were also positive. ThyssenKrupp, the German steel and elevator group, ended a three-year run of multibillion-euro losses with a return to net profit and the promise of a dividend for investors.

Some fund managers are selecting stocks in Europe that are more likely to benefit from a stronger dollar.

"Going into 2015 the currency move will be the biggest factor," says Gerd Kirsten, a European equity manager at Deutsche Bank.

"The big currency moves mean big support for exporters, especially those that export to the US. We find a lot of dollar beneficiaries on the consumer side, in healthcare, industrials and machinery companies." Top stocks in his flagship European fund include Bayer, Linde, Bosch and Novartis.

"If you compare it on a global scale Europe is probably the cheapest region you can get," he adds.

Éric Mijot, a strategist with Amundi Asset Management, says: "If deflationary risk sets in, valuation levels will certainly be downgraded, as will profits – a sort of double penalty. However, if these risks abate, the opposite will occur – a double bonus."