Standard Life
Investments

European Equities

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Global Outlook Q4

STANDARD LIFE INVESTMENTS

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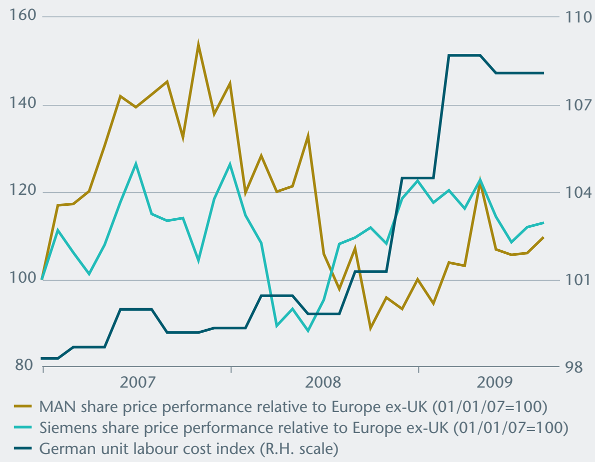
European ex-UK Equities
Coming through the crisis

German companies are refocusing attention on their cost base, while the new world order is creating opportunities for nimble firms.

Will James
Investment Director, Europe

Chart 1
Cost cutting leaders



Source: Thomson Datastream

Renovating for recovery

An export-led economy with manufacturing at its core, Germany has been at the forefront of European economies taking proactive steps to avert mass redundancies in sectors badly affected by the economic downturn. Short-time working is a scheme, effectively subsidised by the German government, which allows employees to retain their jobs while working fewer hours, or none at all. It has been widely taken up by German companies, particularly across the engineering and car making industries, although question marks remain over whether the practice will be extended following September's general election.

We are invested in several German firms that have implemented short-time working, including engineering group MAN, and engineering and industrial conglomerates Siemens and ThyssenKrupp. The chart shows share price performance against a background of rising unit labour costs. The investment appeal of these firms lies not only in their ability to address the impact of reduced volumes on a temporary basis, but to take additional measures to lower fixed costs permanently. For example, MAN has been more successful than many of its peers in tackling the slump within the European trucks industry. The firm has maintained margins through the increased use of temps and hour banks, while exerting a tight pricing discipline and oversight of inventories. We have seen a similarly direct approach to necessary structural change in Siemens, which has already taken significant steps towards cost reduction. We are impressed by its newly invigorated management structure, which bodes well in creating a firm more able and willing to deal with the deterioration than in previous economic cycles. Finally, we favour steel maker ThyssenKrupp. Here, too, we expect management actions to drive a material improvement in the company's profitability, at a level which we consider is not reflected in its current share price valuation.

Banking on change

Amid the aftermath of the global banking crisis, politicians and policymakers around the world have been reiterating demands for a more stringent regulatory environment. Whatever the eventual form of the new rules and legislation, banks will undoubtedly find themselves more reliant on internal IT systems that promote transparent asset exposure. We believe software and IT services firms offering such systems and expertise to aid compliance with the new regulations, such as Swiss-listed Temenos Group and Spain's Indra Sistemas, are well-placed to profit as a result.

Winners List stock Temenos is a likely beneficiary of banks' expected moves to increase expenditure on core banking systems and technology compliant with the wide array of financial reporting and regulatory standards. In our view, the company's breadth of product offering and robust competitive position are underappreciated by the wider market. Meanwhile, Temenos' cost-cutting plans are starting to bear fruit, and its exposure to the budding financial services industry across emerging markets looks set to provide a further source of growth. We also like IT services firm Indra Sistemas, which is competitively differentiated through its specific skills in helping companies implement IT systems. Indra counts Spanish banks Banco Santander and BBVA among its customers. Supporting these firms' global expansion aspirations should continue to cement its position as a specialist provider of solutions and consultancy services. The health of Indra's pipeline is also sustained by its close ties with players across the Spanish utility sector, which has recently undergone a period of consolidation. This in turn is likely to lead to greater demand for integrated IT solutions, which Indra is ideally placed to meet.

Our strategy within European equities

There is evidence of a stabilisation in corporate earnings across Europe, although an upturn in final sales will be the key trigger for a prolonged equity market recovery. More generally, the market is now beginning to price in sensible levels of ongoing profitability for many firms. Our focus on stocks where change is about to happen becomes even more vital against this backdrop. For example, we have recently initiated an investment in Umicore, which recycles precious metals and develops precious metal products for use in batteries, ceramics, tooling and materials for catalysts in automotive industries. We think the market has underestimated the potential benefits to the company of a recovery in the auto production sector, as well as the positive impact any recovery in industrial production will have on recycling activity.

Oct 09

House View

This page sets out our House View as it applies to a UK based balanced fund. Details of how the House View applies to other UK-based funds and funds based in other parts of the world can be obtained from your Standard Life Investments representative.

	Positive	Negative	Our View
US Equities	• The recession is ending in response to major policy measures, such as fiscal packages and quantitative easing • Valuations are attractive, especially as more companies return to profitability	• Squeeze on corporate margins is forcing major cuts in employment and investment • Continued uncertainty about extent of downturn in the housing sector	Market supported by favourable long-term valuations and easier monetary and fiscal policy despite credit concerns STAY HEAVY
European Ex-UK Equities	• Management responding to pressures on margins through cost cutting and more M&A activity • Parts of the region did not experience as large a credit boom as other countries	• Exports remain under pressure due to euro appreciation and sharp slowdown in global trade • Continued concerns about efficacy of policy response in Europe	The region remains vulnerable to the strength of the euro currency impacting on company margins STAY LIGHT
UK Equities	• More aggressive monetary and fiscal support than in many other countries • Valuations such as dividend yields provide underpinning for the market	• Oil and resource companies vulnerable to sharp falls in commodity prices • Concerns remain about extent of consumer and housing bad debts as unemployment rises	Despite concerns about the valuation of a number of cyclical sectors, the market is supported by favourable valuations STAY HEAVY
Japanese Equities	• Japan's financial sector is in a stronger position than in some other countries • Increasing dividends plus share buybacks are helpful for investors	• Companies facing much weaker export demand from the US and Europe • Domestic data suggests economy is suffering a severe recession	Growing concerns about the impact of deflation on profit margins while the policy response is more limited than elsewhere STAY VERY LIGHT
Pacific Basin Ex-Japan Equities	• Infrastructure spending remains a primary driver of many economies • Some governments have taken strong action to support domestic activity	• Earnings at risk from the length of the slowdown in OECD demand • Concerns growing about eventual policy tightening in China to cap inflation risks	Long term valuations remain a concern but governments are taking strong action to support domestic activity STAY LIGHT
Global Emerging Market Equities	• Strong commodity demand is supporting some economies • Current account surpluses protect some countries from credit concerns	• Certain economies still require significant support from international bodies • Some central banks are becoming concerned about inflation risks	Some economies are supported by strong China trade links but others remain vulnerable to capital constraints STAY LIGHT
International Bonds			
US	• Quantitative easing by the US authorities should cap Treasury yields	• Vulnerable to increased supply as the fiscal position deteriorates rapidly	STAY HEAVY within international bonds as Treasuries benefit from quantitative easing
Euro-zone	• Slow response by the monetary authorities to the financial and economic crisis	• Extent of likely debt issuance from easier fiscal policy	STAY HEAVY within international bonds on expectations of further ECB quantitative easing
Japan	• Return of deflation and the lack of policy levers to stimulate economic growth	• Valuations starting to look stretched	MOVED TO VERY LIGHT within international bonds on a comparison of international bond yields
UK Bonds			Within UK bonds:
Gilts	• Interest rates are close to zero, anchoring short-dated gilt yields while the authorities are continuing quantitative easing to affect longer dated yields • Defensive characteristics increasingly recognised	• Continued concerns about the extent of the rise in the public sector deficit • Uncertainty about an exit strategy from quantitative easing is worrying some investors	Stay Heavy in conventional gilts Stay Neutral in index-linked debt
Corporate	• Strong retail and institutional investor demand for extra yield	• Downturn in corporate cash flows will lead to higher corporate bond defaults	Stay Very Heavy corporate bonds Corporate bond valuations remain attractive although individual issues require careful examination
Property			
UK	• Property income yields relative to gilt yields have risen to highs last seen in the 1930s. Evidence of price improvement in 'prime' assets as newly raised capital is invested.	• Rental values are falling in line with a weak economic recovery, especially continuing pressures on the retail sector	We favour well located properties with tenants of good financial strength, plus a sector bias towards core London markets, where future supply is limited, and dominant retail locations MOVED TO NEUTRAL
Global	• Lack of overbuilding in this cycle should support growth in rents as economies emerge from recession. • Infrastructure investment underpins opportunities in emerging markets.	• Credit conditions remain very mixed with commercial bank holdings of property overhanging some markets	We prefer selective high yielding logistics markets in Asia & Central Europe, and office locations with low future supply such as Paris and Sydney.
Cash	• Cash is an attractive alternative when corporate earnings and dividends are under pressure	• Cash yields close to zero are encouraging more investors to seek higher-yielding assets	Official interest rates in major economies are expected to remain low well into 2010 STAY VERY LIGHT

The terms, Very Heavy, Heavy, Light, Very Light and Neutral express Standard Life Investments' view of a balanced portfolio against a given benchmark.