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Q&A

With portfolio manager  
Mark Denning

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## Finding investment opportunities in Europe's recovery

Mark Denning, a portfolio manager in American Funds EuroPacific Growth Fund and other funds, shares his views on Europe's recovering economy and how he prefers domestically oriented European companies. He also discusses:

- Why he is warming up to the airline industry
- Potential value in pharmaceutical companies developing new types of cancer therapies
- Opportunities in the wake of the recent slide in emerging markets
- European banks may be underestimated by the markets
- Japan's corporate sector and its need to show greater profitability



**Mark Denning** is a portfolio manager with responsibilities in several funds, including EuroPacific Growth Fund®, New World Fund® and Capital World Growth and Income Fund®. He has 30 years of investment experience and is based in London.

***Recently we have seen increasing evidence of a turnaround in Europe. What is your thinking about the prospect for a strengthening recovery heading into 2014?***

We are seeing a big pickup in Europe, and that has taken everyone by surprise. The U.K. is growing very strongly. There are signs of stabilization in some of the peripheral countries – Ireland, Spain, Italy. You can even argue that there are positive developments in Greece, though the trouble there is that the debt situation is still huge and remains a significant headwind. Spain now has a current account surplus and, indeed, in March it posted a trade surplus. Spain has become an attractive place to invest. Toll road companies are saying trucking volumes are up; industrial companies are saying they are seeing demand increasing; electricity demand seems to be going up. So Spain seems to be turning around.

I expect that Germany's economy is going to be very interesting in 2014. German industrial indicators are very positive. I think consumption in Germany might grow quite rapidly over the next 18 months and things should continue to improve on the industrial front. So the outlook for Germany is reasonably benign, and indeed you could make a strong case for the rest of Europe, because if Germany starts really moving, it can lift the rest of Europe by its coattails.

The U.K. has also surprised on the upside. Several months ago, companies were telling us they were seeing a big turnaround in the U.K. It is similar to the turnaround in the United States. The housing market is improving. The government enacted a purchase scheme to help buyers, and that seems to have ignited a real pickup in housing demand. You look again at the industrial indicators: exports are up and industry is doing quite well. The service industry is now picking up quite rapidly.

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Over the last five years, for instance, the U.K. service sector in essence has devalued against Singapore's. So suddenly the service sector in the U.K. versus Singapore looks quite attractive.

**Are you concerned about the debt problems in Europe, particularly among the countries in Southern Europe?**

There are reasons to be optimistic about what is going on in Europe. That's not to say it is a certainty, because you have politics to deal with and different nation-states arguing about this and that, which makes it all the more difficult – but that is what democracy is about. Bear in mind, in Europe indebtedness by and large is at the government level, not at the individual level like it is in the United States and the U.K. Personal debt in the U.K. and the U.S. is relatively high, but in Europe it is pretty low. Some people might say that France has a broken system – its government debt is quite high – but the household savings rate in France is more than 15%. These are very high levels of savings. The Italians are some of the wealthiest people on earth because they save and save. So in Europe, we're not talking about issues of individual debt. Europe, in my view, is in a pretty reasonable position headed into 2014.

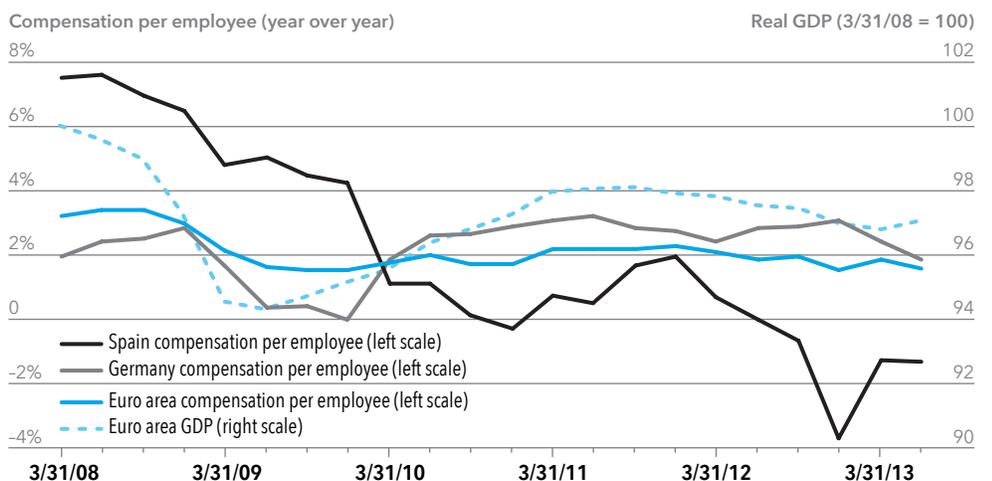
The surprising thing in so many respects is that, for the year to date through the end of September, stocks have risen less in Europe than in the United States. The euro has actually appreciated versus the dollar. And yet all the other currencies around the world are doing the opposite, which tells you one or two things: Europe is really recovering fast, and credit remains quite tight in Europe despite this recovery. The euro is a relatively rare currency in the sense that is the European Central Bank is still running tight policies.

**What are your views on the European financial sector as the region emerges from recession?**

I do think banks are starting to benefit from the recovery. I hold a number of banks and it was very painful for quite a long period of time because I believed they were in far stronger position than was reflected in the market. The bears will argue that the European banks have a lot of bad debts – but keep in mind that a big part of the European banks' books are mortgages. Mortgages in Europe are very high-quality loans, because if you walk away from your mortgage you personally bankrupt yourself. As a result, delinquency rates on mortgages in Europe are

**Exhibit 1:  
 Europe is starting to correct its imbalances with labor costs declining in countries like Spain and many economies are starting to grow again.**

Wage dynamics across the euro area (March 31, 2008 - June 30, 2013)



Source: ECB.

low. What's more, regulators have been through the banks' books with a fine-tooth comb for quite a long time.

There has been a huge consolidation in the banking sector in Europe. In the U.K. there are effectively four or five operational banks, and in France there is probably a similar number. In Ireland, the Bank of Ireland is really the only working bank. If you look at the profitability of a country's banking industry over time, it is directly correlated to the concentration of that industry. For example, there are only about four or five banks in the Canadian and Australian markets – oligopolies – and they do very well. The trouble is, these banks sell at greater than book value. In Europe you can find some banks selling at less than book value. In a concentrated market, if conditions stabilize over time and these European banks make decent profits, at some point they should sell above book value. So, yes, the European banks have issues but they're not as massive as people make out. The major issue is whether the euro is sustainable. If that is the case – and it has been increasingly true over time – then the European banks are quite attractive.

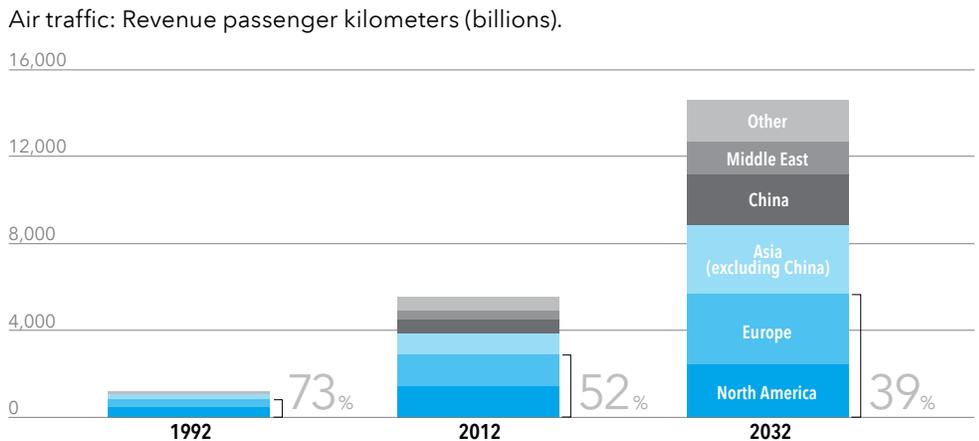
**Are you focusing primarily on the higher quality banks?**

Early on my focus was on the high-quality banks, but as the risks of the euro falling apart have lessened and the banks have further recapitalized, I find that the lower quality banks now look more attractive. Consider that two years ago everyone was saying "Société Générale is a pile of rubbish. Its book is terrible and it is going to have to go to capital markets. It has big problems." Now SocGen is very profitable. It is accumulating capital at a very rapid rate, and the share price has more than doubled from its lows in 2012. The same can happen to some of the second-tier banks.

**In what other areas are you finding value?**

If you look at what's been going on in the U.S. airline industry in terms of consolidation, the same thing is happening in Europe. Now in Europe there are five major airlines: Lufthansa in Germany, Air France-KLM and International Airlines Group, which owns British Airways and Iberia. Then there are Ryanair and EasyJet, discount airlines that are equivalent to Southwest Airlines in the U.S. If energy

**Exhibit 2:**  
**Global travel is expected to grow rapidly, led by the middle class in emerging markets. Airlines are among industries that could benefit from this growth.**



Source: Boeing. Revenue passenger kilometers, or RPK, is the number of fare-paying passengers multiplied by the number of kilometers they fly (i.e., airline traffic).

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prices begin to come down, it will be quite beneficial for the airlines. If demand continues to pick up in Europe – and there is no real growth in capacity – then the airlines should do quite well. Also, in some of the cyclical areas of the market, share valuations don't look expensive. If we see a pickup in earnings, those cyclical areas can also continue to do well.

***Are there any areas of the market that have you concerned?***

From the end of May, with the backup in the U.S. bond market, we have seen a considerable slowdown in the emerging markets. The question is, to what extent has this slowdown been reflected in the share prices of European and U.S. consumer companies? Around 30% of the revenues of the European stock market come from exports to the emerging markets. So if emerging markets are slowing down, that is going to have an impact on European consumer companies. Many of them are selling at high price-to-earnings multiples because people thought there was a huge gravy train in emerging markets. To the extent that growth is reduced, will that be reflected in reduced valuations and reduced share prices? I'm slightly cautious because I think people's expectations for earnings are still too high.

When I think about Europe, I am more interested in the more domestically oriented stocks. I mentioned the airlines. In addition, some of the utilities and transportation companies could do quite well in this environment. Certainly many of them are selling at very cheap valuations. If this economic pickup continues, then perhaps we'll see the light shine on them for a little bit longer than we thought.

***You mentioned the slowdown in emerging markets. Will some regions do better than others?***

I think Southeast Asia is a lot more interesting than other places in emerging markets. For a market that's reliant on commodities, then it is still going to be a

difficult period. It is going to be a difficult period for Brazil; a lot of that is already reflected in share prices. But I think places like Thailand, the Philippines and elsewhere in Southeast Asia can continue to do quite well. Recently, many of these markets have come down by a lot and I think the valuations look attractive.

Elsewhere, huge supply-side changes are taking place in Mexico. Mexico is right next door to the United States and should benefit from U.S. economic growth. Combined with new reforms, Mexico looks like an interesting place to invest. Then you have emerging Europe, which continues to emerge. Take Russia. It has the biggest current account surplus of any major country in the world. There are some wonderful entrepreneurs in Russia – not just the old oligarchs but new entrepreneurs who have started Internet companies, supermarket companies, transportation companies. Those are the sorts of things that I find interesting.

***As emerging economies continue to slow down, what types of companies can thrive?***

The exporters, of course, can do well in a slowdown. In a country like India, where most shares have already been repriced, you have to look at the exporters, because they can benefit from the currency devaluation. The rupee has declined dramatically versus the U.S. dollar, and that has a huge impact on companies like Infosys and Tata Motors.

***How are portfolio managers of EuroPacific Growth Fund positioning the fund for the environment you have described?***

We've been adding to our investments in European financials. There has been more of a move into cyclically oriented companies in Europe. And we have been reducing some of our growth-oriented holdings, including some in the emerging markets. It is still a work in progress and I certainly have been

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shifting my portfolio. Companies today adapt very quickly, especially in some emerging markets. They are used to the volatility and the uncertainty. As an example, managements at Brazilian companies adapt far better and far quicker than many Western companies. Just because the economy is not doing spectacularly well doesn't mean that the stock market doesn't do well. It really comes down to selecting great companies.

So when you see all the headlines about developing economies slowing down, take it in, but then go and look for companies that have gone down in valuation but are still great long-term investments. A lot of those are out there, particularly in Asia and Latin America. I believe there is value in Southeast Asia and other emerging markets, but there is no need to rush into them.

***Japan's economy has been growing faster than many expected following some aggressive fiscal and monetary measures taken by the Abe government and the Bank of Japan. Are you looking in Japan for investment opportunities?***

I am always looking at companies in Japan, and certainly there has been a sea change in terms of attitudes – at least from the government. But it is one thing to say you are going to change things, and another thing to actually change things. However, there is an awful lot of competition in Japan, which means that in aggregate, Japanese industry is not highly profitable. You look at so many service sector industries that are highly fragmented with many small and often not very profitable companies and as a result it is difficult to make decent rates of return. I don't see companies consolidating and trying to be more profitable.

Now that is a gross generalization, and there are some great Japanese companies. Take SoftBank as an example. There you have a founder and CEO, Masayoshi Son, who has great entrepreneurial vision.

He took over Vodafone's mobile phone business in Japan, turned it around and has let it grow. In the U.S., SoftBank merged with Sprint in July. He has invested all over the world in the Internet and has done very well. So there are good companies, but it is difficult for me to get wildly bullish about the Japanese market overall.

***We've seen a wave of consolidation in the telecommunication services sector recently. What are your thoughts?***

Telecommunications is both a global and a local business – local in the sense that it is driven so much by regulation and industry structure. In India, for instance, there are 10 or more operators. When you have such a fragmented market, it becomes very difficult to make above-average returns. In contrast, the U.S. is essentially down to two operators – AT&T and Verizon – and as a result, those companies are making substantial sums of money. Now SoftBank is getting into the U.S. market by buying into Sprint and revitalizing it. I think similar consolidation will take place in Europe and the rest of the developed world. We could very well see a few large companies emerge, which would be better for their profitability. Their capital expenditure needs are huge and it makes sense for the global companies to consolidate. There are a few acquisition candidates in Europe, but we won't invest purely on an M&A thesis. In some of these cases, it is better to see how the consolidation takes shape.

***You have shown some interest in pharmaceuticals. What are your thoughts on that sector?***

I've liked the pharmaceuticals industry as an investment. It benefits from favorable demographic and macro factors: an aging population means greater spending on drugs, emerging markets growth, and so on. The one ingredient that has been missing over the last 10 years has been innovation. Basically, investors have valued the pharmaceuticals pipeline at zero.

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But today there is some real innovation in therapies and therapeutics. One example is cancer: some very new, interesting lines of attack are being developed based on using the immune system to attack cancer cells by turbocharging, or putting the immune system on steroids. Several of the major pharmaceutical companies – including Bristol-Meyers Squibb, Roche and Novartis – all have some very interesting ideas and treatments in development.

Many investors think that pharmaceuticals have already been rerated, but in my view, they still have many years of good growth ahead of them. And they're paying good dividends and growing those dividends, and the absolute valuations are not high. So I continue to find pharmaceuticals very attractive.

*Based on an interview conducted on September 12, 2013.*

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