



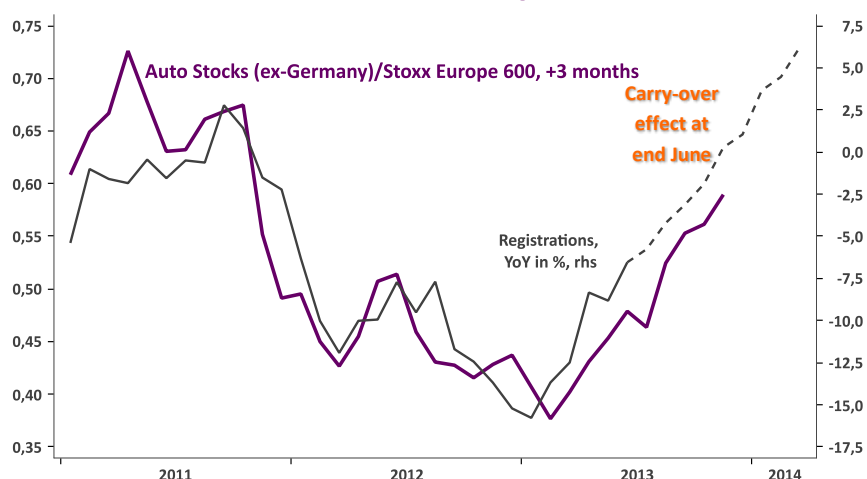
Bright Spots in an Otherwise Lackluster Recovery, Part 1: The Auto Industry

Although there are still legitimate concerns about the future of the euro area, the recession is definitely over. Like all such episodes, this one comes with a number of pleasant surprises. Here are the three main ones:

- The first and most significant surprise from the investor standpoint is a recovery in Europe's auto industry, along with improved stock performance for the firms involved.
- The second—and much more surprising—surprise is that the indicators we track on the French economy show a brighter outlook for industrial investment in France.
- The third, and possibly most important surprise—given the risks that Spain's sluggish economy pose for Europe as a whole—is that spending by Spanish consumers is clearly trending upward.

While none of these surprises taken alone has enough weight at this point to convince us to make any major changes to our growth forecasts, they each help restore a modicum of confidence—perhaps even with unexpected repercussions. **Today's article zeroes in on the first of these trends, a recovery in the auto industry, whose firms, at least outside of Germany, can almost certainly look forward to further robust stock performance.**

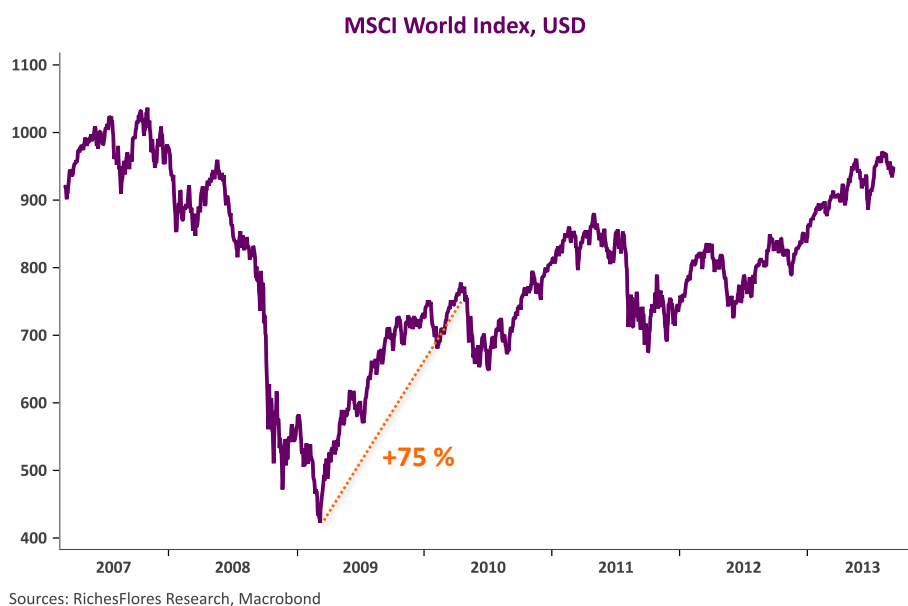
Relative Performance of Automotive Stocks (ex-Germany) vs. the Stoxx Europe 600, and YoY Growth in New Car Registrations



Sources: RichesFlores Research, Macrobond

Leaving the Thorny Issues Aside—for the Moment

Lingering apprehension tends to be a hallmark of exits from recessions. When scars of a preceding crisis are still all too visible, people find it hard to take good news at face value. That's why when the first green shoots came up in March 2009, genuine believers were thin on the ground. Since the global economy was perceived to be mired in a "regime crisis," a mere end to the recession seemed unconvincing, and many warned it would lead at best to feeble long-term growth. But however well-founded their warning may have been, the fact remains that spectacular improvement had indeed occurred in several areas. Particularly noteworthy is that the global automotive industry took less than six months to bounce back to its former level, and world trade less than a year. At the same time, corporate earnings shot up. A by-product of these developments was a vigorous upswing in equities worldwide, with stock markets rallying as much as 75 percent in the twelve months after they bottomed. It wasn't until spring 2010 that thornier structural issues reappeared on the radar and overshadowed the bullish market trend.



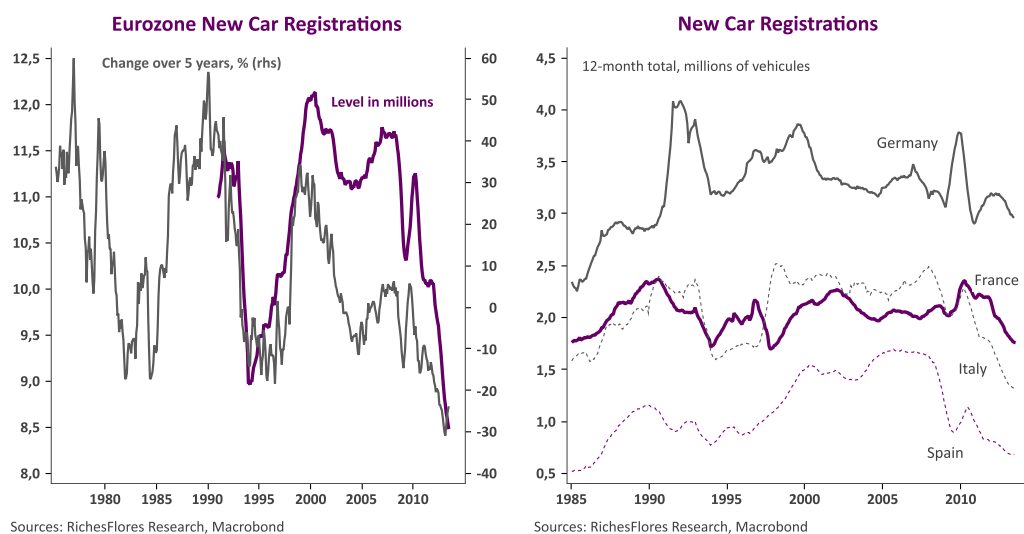
The deep crisis experienced by the euro area in the last few quarters has understandably bred skepticism. What's more, recent forecasts are nothing to get excited about. The August consensus is that the Eurozone economy will grow by less than 1 percent next year—after contracting 0.6 percent this one—while the jobless rate will continue to creep up, rising from 12.2 percent in 2013 to 12.3 percent in 2014. Our own forecast is fairly similar, but we predict even slightly lower growth in 2014.

Even so, the current recovery, like all recoveries, already harbors a number of pleasant surprises. We have distinguished three main ones: a brighter outlook for Europe's auto industry, the likelihood of higher industrial investment in France, and rising consumer spending in Spain. It is worth noting that none of this good news has come from Germany—if anything, the country's performance has fallen short of

expectations. In this paper, we focus on the first of these trends: a peppier automotive industry.

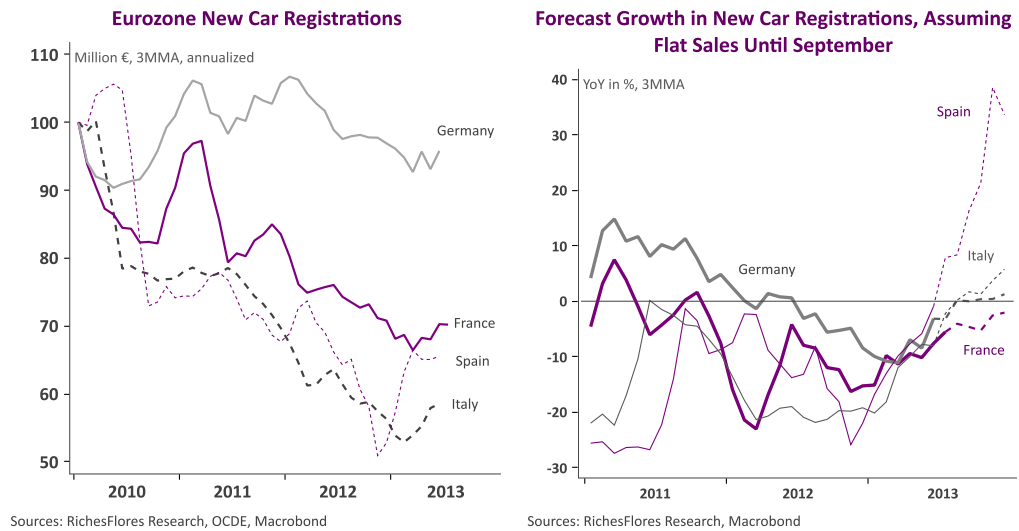
The Auto Industry (ex-Germany): Strong Potential for Further Stock Market Outperformance

Europe's automotive industry was one of the sectors most severely battered by the recession of the last several quarters. After a brief lull in the wake of the 2008 crisis, the industry went into an uninterrupted tailspin from spring 2010 to the end of 2012. This put the brakes on new vehicle registrations, which fell at a clip of 25 percent a year—making this the European auto industry's longest slump on record. By early 2013, new car registrations in most countries—Germany included—had tumbled to levels not seen since the 1990s, if not lower.



The uptick in sales since the beginning of the year, including a net rebound in Spain and, to a lesser extent, in Italy and France, suggests that the auto industry may soon be recovering a good deal of lost ground. Although in today's uncertain economic climate it may take a while for annual registrations to return to a level consistent with the high average age of cars on the road, the fundamentals driving the industry rebound will still be prevalent in the next several months. Assuming sales settle in at their latest recorded level (June or July, depending on the country) by the close of the year—a plausible yet conservative assumption—registrations will show steady, substantial annual increases in the upcoming months:

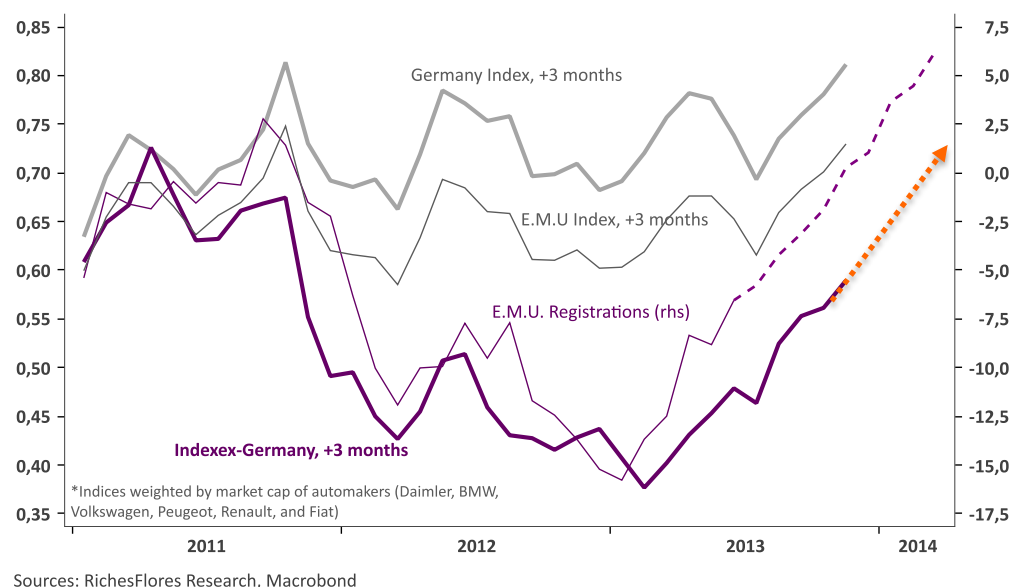
- By year-end, the Spanish car market will be growing at better than 35 percent a year, in contrast to a 26 percent contraction in November 2012, when vehicle sales hit a low in the country.
- In Italy, where new car registrations slid 20 percent in January, the market will finish the year up 6 percent.
- The French market will bottom out, instead of declining by 16 percent as it did in the trough of the cycle (November 2012), and move clearly back into positive territory as of the first quarter of 2014—the same time as the German market.



These underlying trends go a long way toward explaining the resilient auto-industry stock prices of the past few months. Automakers outside Germany have been particularly well-positioned to cash in on the European recovery.

In fact, the main reason why auto-industry stocks as a whole have been so uncorrelated with domestic market trends in the past two years is that Germany's automakers are heavily exposed to overseas markets, especially China. **Once you remove those outliers from the equation, stock prices for Europe's automakers correlate much more closely with new car registrations in the region, in both absolute and relative terms** (see chart below). So if we are right in assuming that in the worst-case scenario, Eurozone car sales will remain flat between now and year-end, auto-industry stocks, excluding Germany, are likely to keep outperforming the Stoxx Europe 600—as they have since the start of the year. **All other things being equal, we forecast a 25 percent outperformance between now and the end of Q1 2014.**

Relative Performance of Automotive Stocks* vs. the Stoxx Europe 600, and YoY Growth in New Car Registrations



There are even grounds for expecting part of this outperformance to be achieved at German automakers' expense. Not only are high-end German models in a weak position to benefit from rising car sales in Europe; the worsening outlook for emerging economies almost certainly spells serious trouble for German exports.

All this suggests that developments over the next few months may paint a picture of Eurozone car markets that is quite unlike what we've seen in the last two years.

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