



Equities

Vive la France, long live Europe and its equities

Political risks seem tamed for now, and valuations don't appear stretched. This allows markets to focus on Europe's earnings revival. We have upgraded the region.

Time to rediscover Europe

What we believe to have been the single biggest political risk in Europe in the current year was happily averted with the outcome of the French elections. Populist tides also appear to have peaked for the time being. We have taken this occasion to upgrade European equities to overweight as we believe political uncertainty has been the main factor that has kept investors, especially foreign investors, from shifting their funds to Europe. Europe's advantages can no longer go unnoticed. Alongside the stable macroeconomic environment, it's the earnings momentum of European companies that makes a strong case for investing in Europe. This year Europe should finally see the turning point, now that decent earnings growth is back after six flattish years. We expect double-digit earnings growth versus last year. So far, the reporting season has supported our positive fundamental outlook. European equities are trading at reasonable multiples, especially compared to those in the United States. Although many investors say they find Europe attractive again, this view is not yet broadly reflected in their investment allocations.

Politics – anti-European sentiment is losing steam

We see a slight easing in political risk across Europe. After the elections in the Netherlands and Austria and the right-wing Alternative for Germany (AfD) party's decline in the German polls, it is now the French elections that are pointing to the fact that the year 2017 could be the apex for (anti-European) populists.¹ With Emmanuel Macron, there is a committed European leading Germany's most important political partner. His taking the helm could accelerate investor hopes for further European integration, perhaps in the form of a better coordinated and more stimulating fiscal policy.

That said, it's important not to sugarcoat the election results because they also reveal a high degree of political dissatisfaction and loss of confidence in the established parties on the part of voters. This will not be Macron's only challenge, as he cannot rely on an established party and it's still unclear how many votes in parliament he can count on. Macron's recent rapid success as well as his personality, however, leave us with hope that he will be able to launch some reforms.

Next to Brexit, which in our opinion will be of little help in boosting Europe's economy, we are left with Italy as the largest single risk

Britta Weidenbach
Head of European Equities



Our expectations in a nutshell

- Europe's corporate earnings are set to grow again in 2017, even by double digits
- Earnings dynamics and valuations are especially compelling compared to the U.S.
- With Macron's win, the biggest political risk seems to have dissipated. We upgrade Europe.

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¹The "Pulse of Europe" movement is also a sign of the growing support for Europe. After being founded in Frankfurt just around six months ago, this movement already has around 50,000 supporters who have taken to the streets in more than 100 cities in 14 European countries.



factor. Political dissatisfaction and a fragile banking sector are being met with fading economic growth. Still, we do not expect Italy to hold new elections before the fourth quarter of 2017. And even if the outcome is unfavorable, we would still be a long way away from an EU referendum.

Europe's economy – headed in the right direction

A dynamic United States on the one side and a self-preoccupied Europe on the other. Although this is the popularly held opinion, with 1.8% growth in Europe versus 1.6% in the United States, the gross domestic product (GDP) in 2016 has already contradicted this notion. In addition, we have had positive economic-growth surprises coming out of Europe in the first quarter of this year whereas the United States again surprised to the downside. It's certainly true that discussions about Europe over the past few years have rarely contained the words "overheating" and "economy" in the same sentence. After all, it took until the third quarter of 2015 before the EU's GDP (based on 19 members) was able to finally surpass the level achieved in the first quarter of 2008. But now Europe is headed back in the right direction. According to consensus expectations, real GDP growth will be 1.8% in 2017 (2018: 1.7%), which in our view would mean the economy is already growing well above its potential (about 1 to 1.2%).

We find the following five trends particularly encouraging:

- Consumer confidence, purchasing managers' surveys and the IFO index are at longtime highs in most cases.

Economic sentiment trending higher in Europe



Source: Thomson Reuters Datastream; as of 4/28/17

* European Commission survey; corporates and consumers

- Order intake, industrial production, credit lending and wages are also continuing to rise.
- The unemployment rate has been declining since mid-2013 and is close to falling to below 8% in the European Union for the first time since 2008; since last summer, unemployment in the Eurozone has returned to below 10% (the high was 12%) and is now at the same level as in 2009.
- Europe's high-export economy continues to benefit from the stability achieved in some of the emerging markets and momentum gathering in other emerging markets. We expect

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global economic growth to reach 3.5% in 2017 (2018: 3.7%) compared to 3.1% in 2016.

- Trump's protectionist bias should not be ignored. However, his (declared) retreat from the long-announced exit from NAFTA and other changes in strategy provide hope that any protectionism will be limited to individual sanctions.

Europe also appears to have left the daunting issue of inflation behind. In April, the Eurozone reported inflation of 1.9% (core inflation of 1.2%). We expect inflation to reach 1.7% (1.1%) for the full year. The financial sector is likely to be particularly pleased with the gradual rise in interest rates and the prospect of a normalization of the European Central Bank's (ECB's) monetary policy. However, we no longer expect the ECB to take any action this year to reverse negative deposit rates. We also do not expect to see any strong tail- or headwinds from the euro. From its low in April 2015, the trade-weighted euro has risen only seven percent to date. Assuming no further political hiccups in the Eurozone and a further increase in European interest rates, the trend could potentially continue over the medium term. Even so, it's unlikely this would pose a major problem for exporters at that level. We expect the gap between perception and reality to continue to close when it comes to Europe. Concerns about the political risks have long dominated the discussion. Now the focus should return to the economic data that is slowly but solidly improving.

European equities – earnings growth is back again

After the outcome of the first round of presidential elections in France, we raised our rating on European equities to overweight in an international context. The key arguments for the upgrade include solid fundamental data – especially earnings momentum – and the fact that valuations are reasonable and politics are no longer standing in markets' way. While investor interest in the second half of 2016 was still very much focused on the United States and uncertainty prevailed over the situation in Europe, we believe the interest has now shifted to Europe. American investors and companies may have come to acknowledge that it's a long hard road between Trump's perceived business-friendly policies and their implementation, which for some policies is no longer likely to take place this year. Companies in Europe, on the other hand, are brimming with confidence and presenting results that are pushing earnings estimates higher. All this is happening amid a stabilized political environment and improving macroeconomic indicators. Added to this is the fact that European companies benefit more from a pick-up in growth – particularly in the emerging markets – because they are more dependent on global growth than companies in other countries. Investors can already see this in the results from the current reporting season. Right now, we are especially positive about earnings growth, flow data and valuations.

Earnings dynamics: The first quarter reporting season is going very well for European stocks. Morgan Stanley's analysis of the quarterly reports of 113 Stoxx 600 Index companies that had reported before May 2nd shows a total of 43% managed to beat expectations by more than 5%. Only 20% missed by more than 5%. By this measure,

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this has been the strongest quarter in ten years. So far, quarterly earnings are some 19% higher year-over-year.

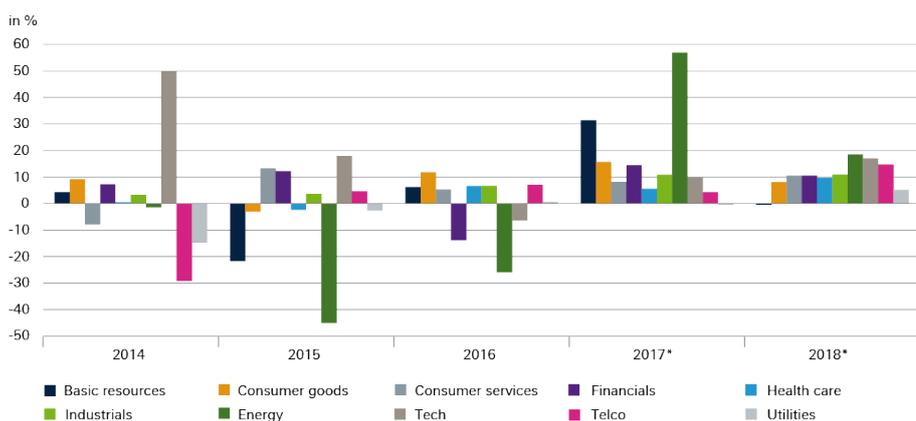
These results are also reflected in the year-to-date changes in consensus estimates for 2017 earnings per share (EPS). Usually analysts have to bring down their estimates at the start of the year (which is still the case this year in the U.S.), but things are different this year in Europe: consensus earnings are currently almost one percent higher than in January, and the estimates for the Dax companies are even up by a total of three percent.

A strong year: development of 2017 EPS forecasts



We expect **earnings growth** in Europe (Stoxx 600 Index) to reach 10.9% in the next twelve months (consensus is even almost 4% higher). Double-digit growth was last achieved in 2010. For the first time in years, this growth originates from all nine sectors. This compares to the past two years of earnings disappointments for the index, which were dominated by only a few sectors.

Broad-based recovery: EPS growth of Stoxx 600 sectors



Despite our skepticism regarding the suitability of **flow data** as an early indicator, this flow data, tracking the movement of larger asset positions (for example, by institutional investors or ETFs), has been indicating a shift in assets to Europe for several weeks. Furthermore, there is an increase in the (anecdotal) interest of international investors, who had been steering well clear of Europe for a long time.

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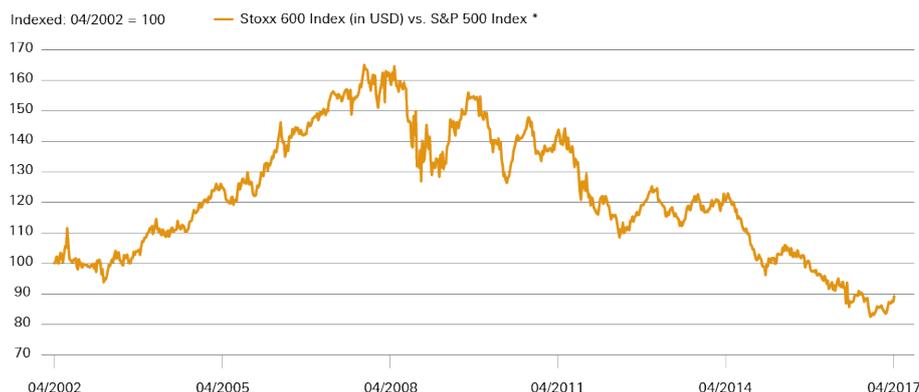
Current **valuations** on a historical basis are not the most striking argument for European equities, despite room for further gains. European equities do look interesting, however, when compared to other asset classes such as bonds or even U.S. equities.

- In the next 12 months, we expect the dividend yield on the Stoxx 600 Index to amount to 3.6%. Aside from government bonds, even high-yield bonds in Europe (on average) currently do not reach this kind of yield.
- European equities traditionally trade at a discount to U.S. equities. A few of the key ratios, such as the price-to-book ratio have drifted again to the lower end of the range.
- The difference between U.S. and European profit margins may have peaked given that wage pressures are significantly higher in the United States than in Europe.

Not only financial investors, but also strategic investors are seeing the advantages of Europe. M&A activity is picking up again, and we expect the number of transactions to increase, particularly for smaller companies.

Although the dynamic earnings streak is expected to continue, investors should stay tactically flexible in this global market environment. At the same time, however, with Europe outpacing the U.S. (S&P 500 Index) since the beginning of the year, investors shouldn't worry about having missed some of the rally. After all, Europe has been lagging for a good ten years now. Investors should also not be dissuaded by the fact that Europe is on everyone's lips at the moment. While it might not be a contrarian's preferred investment strategy, past quarters have shown that following the consensus can also prove to be the right strategy.

Long cycles: relative performance of Europe vs. U.S.



Sources: Thomson Reuters Datastream; as of 4/28/17
* total-return indices

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Glossary

Contrarian

Contrarian investing is an investment strategy that is characterized by positioning oneself in the opposite direction of prevailing sentiment.

Dax

The Dax is a blue-chip stock-market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

Earnings per share (EPS)

Earnings per share (EPS) is calculated as a companies' net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Emerging markets (EM)

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

European Central Bank (ECB)

The European Central Bank (ECB) is the central bank for the Eurozone.

European Union (EU)

The European Union (EU) is a political and economic union of 28 member states located primarily in Europe.

Eurozone

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Gross domestic product (GDP)

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Mergers and acquisitions (M&A)

Mergers and acquisitions (M&A) are the two key methods of corporate consolidation. A merger is a combination of two companies to form a new company, while an acquisition is the purchase of one company by another in which no new company is formed.

North American Free Trade Agreement (NAFTA)

The North American Free Trade Agreement (NAFTA) is a trade agreement signed by Canada, Mexico and the United States, creating a trilateral trade bloc in North America, which came into force on January 1st, 1994.

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Price-to-book (P/B) ratio or multiple

Price-to-book (P/B) ratio or multiple compares a stock's market value with its book value.

S&P 500 Index

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Stoxx Europe 600 Index

The Stoxx Europe 600 Index is an index representing the performance of 600 listed companies across 18 European countries.

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