Morgan Stanley

INVESTMENT MANAGEMENT

The Markets – A Review

ACTIVE FUNDAMENTAL EQUITY | EUROPEAN EQUITY TEAM | MACRO INSIGHT | DECEMBER 2016

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European markets finished the month on a firm note, as the MSCI Europe Index rose +5.8% month-over-month (in Euros) with all sectors posting positive returns. The best performing amongst them were technology (+11%), energy (11%) and autos (+10%).

The Italians rejected the constitutional reforms suggested and Prime Minister Matteo Renzi stepped down, triggering a short-lived crisis. A new government was promptly appointed, with the former minister of foreign affairs selected as the new Prime Minister (PM). One of his first tasks is to provide some sort of relief to the beleaguered banking system in Italy, starting from the third-largest lender Monte dei Paschi di Siena which will be nationalised following the failed attempt to execute on its recapitalization plan.

On the policy front, the European Central Bank (ECB) announced it would continue its asset purchase programme at a monthly pace of €80bn until March 2017, with an intention to reduce to €60bn per month until the end of December 2017 or beyond. Data-wise, European Monetary Union (EU) retail sales (1.1% vs cons 0.8%) and German factory orders surprised to the upside (4.9% vs cons 0.6%), whilst German industrial production disappointed (0.3% vs cons 0.8%).[1]

In the U.K., Brexit headlines heated up ahead of the official triggering of Article 50 with the government promising to present its plans to parliament ahead of the intended March 2017 deadline. PM Theresa May indicated that the U.K. cannot remain a member of the single market after leaving the European Union. As a consequence, Sterling continued to weaken against both Euro and USD.

[1] Morgan Stanley Research, January 2017.

December saw the Federal Reserve (Fed) hiking the policy rate by 25 basis points. The new rate was already fully priced in by the market. The move continued to strengthen the USD on a trade weighted basis, as both Euro and GBP continued to weaken.

In December, the best-performing sectors in the European equity markets were:[2]

- Technology hardware (+11%)
- Energy (+10%)
- Automobiles & components (+10%)

Key laggards in the European equity markets for the same time period were:

- Retailing (+0%)
- Commercial services (+4%)
- Materials (+4%)

For the full 2016, semiconductors (+35%), energy (+33%) and materials (+29%) were the best sectors; conversely, technology (-28%), retailing (-14%) and telecommunications (-13%) were the key laggards.[3]

Morgan Stanley Investment Management (MSIM) European Equities

During the month, we did not make any significant changes to the portfolios as we believe they are well positioned in the current environment.

The European Equity Alpha Strategy remains overweight technology, telecommunications, health care and consumer staples. We are underweight materials, utilities, real estate, consumer discretionary and financials.

In the Eurozone Equity Alpha Strategy, our biggest overweight sectors are industrials, financials and technology. We are underweight utilities, consumer staples, health care, real estate and materials.

Information in this section is as at 31 December and is subject to change on a daily basis. This data is provided for informational purposes and is not intended to be an investment recommendation in regards to any securities, sectors or countries mentioned herein.

Consider This

We believe that European equities have an excellent opportunity to break out of the trading range they have been stuck in over the past couple of years. In particular, we highlight five reasons to be optimistic for the asset class in 2017:

- Improving global economic outlook, with a strengthening U.S. outlook courtesy of renewed prospects for fiscal stimulus; stabilising emerging markets growth and European leading indicators pointing to a more sustainable gross domestic product outlook.
- Weak Euro and GBP against USD, as the Fed continues its tightening policy. The spread between U.S. Treasuries and the German Bund will put pressure on the single currency, providing a support for Eurozone exports.
- Expansionary monetary policy in Europe, as the ECB continues with its quantitative easing program until at least December 2017.
- Inflation is on the rise in developed markets. The bottoming out of inflation expectations is a significant step forward as it reduces deflationary fears and we begin to see the light at the end of the tunnel regarding accommodative monetary policies in developed markets. Equities, being a natural inflation hedge, tend to outperform fixed income securities when the yield curve steepens.
- Bottoming out of European corporate earnings, as the turn in commodity prices and improving banks' profitability should offer a rebound to corporate earnings after five years of negative results. Falling unemployment figures and rising inflation expectations should also support corporate pricing power, enabling European companies to improve their depressed margins.

Over the past few months we have witnessed a strong sector rotation, out of defensive, high-quality players into more cyclical stocks, mainly in sectors such as banks, materials and energy. Bond yields rose and will probably be key to understand if the abovementioned sector rotation has further to go. During the first trading sessions of the new year, bond yields appear to be stalling, as investors await more clarity on Trump's economic policies and implementation timeline. Oil prices have also stabilised over the past few months. Banks should start to demonstrate that their new margins are sustainable as valuations have significantly moved from the summer lows and these levels of valuations would become harder to justify without any long-term profitability improvements.

[2] FactSet, December 2016.
[3] FactSet, December 2016.

Performance – Morgan Stanley Investment Funds (MS INVF)

Data as at 31 December 2016.

	1 MONTH %	YTD %	1 YEAR %	3 YEARS ANN. %	5 YEARS ANN. %	10 YEARS ANN. %
MS INVF European Equity Alpha Fund	5.78	-0.27	-0.27	2.78	9.07	2.79
MSCI Europe Index	5.84	2.58	2.58	5.85	10.76	2.63
ALPHA	**-0.06**	**-2.85**	**-2.85**	**-3.07**	**-1.69**	**0.16**
MS INVF Eurozone Equity Alpha Fund	6.51	3.59	3.59	5.26	13.12	3.23
MSCI EMU Index	6.94	4.37	4.37	6.14	11.97	1.33
ALPHA	**-0.43**	**-0.78**	**-0.78**	**-0.88**	**1.15**	**1.90**

Source: Morgan Stanley Investment Management

Note: Past performance is not a reliable indicator of future performance. Performance is shown net of fees and for the I share class, in base currency of EUR.

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