Morgan Stanley

INVESTMENT MANAGEMENT

The Markets – A Review

ACTIVE FUNDAMENTAL EQUITY | EUROPEAN EQUITY TEAM | MACRO INSIGHT | APRIL 2017

The MSCI Europe Index rose +1.7% month-over-month, with industrials and consumer discretionary leading the broad index. Telecommunications, energy and utilities were the key laggards. The Euro was up 2% versus the USD.[1]

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The French elections are now over. Emmanuel Macron comfortably beat Marine Le Pen in the second round and, for the time being, the markets can put political risk to one side and focus on earnings and macroeconomic data.

First-quarter earnings got off to a very strong start, with the breadth of revenue the strongest we have seen in 14 years of data. Analysts are upgrading numbers in response to the strong set of results. Roughly 70% of companies have seen upgrades to their respective year-end earnings-per-share (EPS) estimates, the highest in five years.[2]

Crude oil broke below the all-important psychological $50/bbl barrier weighing on the energy sector (-7% YTD). We continue to remain neutral on energy stocks.

On the macro front, key industrial and export releases came in better than expected as well as retails sales, which printed a gain of 1.8% month-over-month (versus consensus 0.7%). The European Composite PMI came in at 56.4—a fresh six-year high. Confidence around inflation remained low, with risks to the economic outlook being described as balanced.[3]

In the U.K., Prime Minister May triggered an early election scheduled for June as Survation polls indicated that the Conservative party's majority would increase substantially,

[1] Morgan Stanley Research, FactSet and MSIM.
[2] Barclays Research; as of May 1, 2017.
[3] Morgan Stanley Research; as of May 1, 2017.

implying a smoother domestic political path through Brexit talks.

In April, the best-performing sectors in the European equity markets were:[4]

- Consumer durables & apparel (+7%)
- Consumer services (+5%)
- Capital goods (+5%)

April key laggards:[4]

- Telecommunications (-3%)
- Energy (-2%)
- Utilities (-2%)

YTD, the best-performing sectors in the European Equity markets are:[4]

- Consumer durables & apparel (+21%)
- Household & personal products (+15%)
- Capital goods (+15%)

YTD key laggards:[4]

- Energy (-7%)
- Food & staples retailing (-1%)
- Retailing (+1%)

MSIM European Equities

During the month, we decided to take some profit in Irish building material company CRH, Swedish truck company Volvo, Dutch staples company Unilever, French industrial company Schneider Electric and French utility Suez. We continued to build up a position in German chemical company Symrise and Bayer. We also topped up our position in German tyre manufacturer Continental.

We initiated a position in U.K. REIT Great Portland Estates. Great Portland specialises in West-End London commercial properties. London West-End tenant demand is healthy, driven by a diverse and generally non-financial tenant base. We believe that Great Portland owns an excellent property portfolio, is in a very strong financial position with very little gearing and trades at undemanding valuations.

The MS INVF European Equity Alpha Fund remains overweight health care, technology, telecommunications and consumer staples. It remains underweight energy, industrials, real estate, consumer discretionary, materials and utilities.

In the MS INVF Eurozone Equity Alpha Fund, we took some profit in Dutch household and personal care company Unilever and topped up our position in German pharmaceutical company Bayer.

In the MS INVF Eurozone Equity Alpha Fund, our biggest overweight sectors are industrials, health care, technology and telecommunications. We are underweight utilities, real estate and materials.

We did not make significant changes in the MS INVF European Champions Fund, which is overweight consumer discretionary, consumer staples, technology, healthcare and industrials. It remains underweight materials, utilities, energy, telecommunications and financials.

Information in this section is as at 30 April 2017 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

- **LOWER POLITICAL RISK**

  With the recent Dutch and French elections behind us and markets reacting positively with the outcome, all the attention is now on the German elections in September, where polls largely predict a market-friendly coalition. We believe that reduced political risk in Europe will encourage international investors to concentrate on the fundamentals of European equities. Furthermore, over the past few years, Europe has been starting to address one of the main issues of concern for investors: the banking system. We believe that through consolidation, improving regulatory frameworks and by putting additional capital in the system, banks are now on a much more solid footing than a few years ago.

- **ROBUST GLOBAL GROWTH**

  Global growth has been steadily improving for more than a year. The U.S. economy has reached full employment, and the potential tax cuts promised by the Trump Administration may well continue to support economic growth. Emerging markets economies, led by Brazil and China, have stabilised, supported by a rebound in commodity prices. European economic growth forecasts have been recently upgraded by Morgan Stanley economists; they now estimate European gross domestic product (GDP) growth of 1.8% for this year and 1.7% for 2018. The outlook is for further GDP improvements. PMI has been very strong recently, with April printing its best level in seven years. We believe that if PMIs fail to move higher from here, it could limit the potential for further upgrades to cyclicals' earnings. The strong first-quarter earnings delivery—which was helped by the rebound in commodities, by the favourable base effects and by the robust activity—will not be repeated in the second quarter. Cyclicals have delivered strong first-quarter results, which helped their relative performance versus defensive sectors.[4]

- **EUROPE OFFERS HIGH INTERNATIONAL EXPOSURE**

  The European economy is much more geared to the global economic cycle. In fact, European companies have on average only 53% of their revenue exposure to the domestic market. The same number for U.S. companies is 69%.[5] We believe that European companies could therefore offer a very high degree of exposure to global growth.

- **EUROPEAN ACCOMMODATIVE MONETARY POLICY**

  Morgan Stanley economists believe that the European Central Bank (ECB) will continue to maintain a benign position, providing support to the economic recovery. Expectations are for a gradual ECB tapering from January 2018 and a first deposit increase only in September 2018.[6] On the contrary, the Federal Reserve is already in tightening mode, and market consensus is for an additional two interest rates hike in the U.S. before the end of the current year.

[4] FactSet; as of May 1, 2017.

[5] Goldman Sachs Investment Research, April 2017.

[6] Morgan Stanley Research, April 2017.

Performance – Morgan Stanley Investment Funds (MS INVF)

Data as at 30th April 2017.

	1 MONTH %	YTD %	1 YEAR %	3 YEARS ANN. %	5 YEARS ANN. %	10 YEARS ANN. %
MS INVF European Equity Alpha Fund	1.87	7.29	13.02	4.78	9.05	2.90
MSCI Europe Index	1.69	7.74	16.67	7.11	11.11	2.72
ALPHA	**0.18**	**-0.45**	**-3.65**	**-2.33**	**-2.06**	**0.18**
MS INVF Eurozone Equity Alpha Fund	2.69	9.43	19.13	7.84	13.72	3.47
MSCI EMU Index	2.28	9.55	21.06	8.04	13.11	1.52
ALPHA	**0.41**	**-0.12**	**-1.93**	**-0.20**	**0.61**	**1.95**
MS INVF European Champions Fund[8]	2.88	11.25	18.74	–	–	–
MSCI Europe Index	1.69	7.74	16.67	–	–	–
ALPHA	**1.19**	**3.51**	**2.07**	**–**	**–**	**–**

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.

- **EUROPE OFFERS CHEAPER EQUITY VALUATIONS**
  Over a 10-year period, the S&P 500's valuation is more than one standard deviation over its long-term average and globally it is the most expensive market both in absolute and relative terms.[7] Europe, on the other hand, trades at a multi-year low compared to the U.S. By starting from a very low base, both in relative and absolute terms, we believe that European equities offer a greater degree of upside potential in the coming years.

[7] Goldman Sachs Investment Research, April 2017.

[8] Inception date of the Fund is 8th April 2016.

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