

The Markets – A Review

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

The MSCI Europe Index fell by -0.40% during July. The best-performing sectors were semiconductors (+5%), insurance (+3%) and banks (+3%), whilst the biggest laggards were pharmaceuticals (-5%), health care equipment (-4%) and food beverage & tobacco (-4%).¹

Earnings season delivered the softest quarter since fourth-quarter 2014, with capital goods, diversified financials and utilities delivering the weakest results whilst banks and materials delivered the strongest. Europe's earnings revisions ratio fell to a one-year low, with financials remaining the only source of earnings upgrades.²

On the macro front, the IFO business climate printed a new all-time high of 116 (versus consensus of 115), German industrial production delivered a solid gain of 1.2% (versus consensus 0.2%) and manufacturing orders came in ahead of expectations. In the U.K., the purchasing managers' index (PMI) signalled a slowing momentum and consumer confidence fell back to levels last seen in June 2016 (Brexit). Despite this, the labour market report was resilient, showing that unemployment fell to a low of 4.5%.³

In the eurozone, economic data came in strong, with Mr. Draghi adopting a more hawkish stance. In the last European Central Bank (ECB) meeting, Mr. Draghi didn't push back against a stronger Euro. As a consequence, the EUR/USD appreciated 3.64% month-over-month.

German 10-year yields broke above the 0.50% level for the first time since January 2016, following hawkish comments by President Draghi in the last week of June.

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¹ FactSet, August 2017.

² Morgan Stanley Research, August 2017.

³ Morgan Stanley Research, August 2017.

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In July, the best-performing sectors in the European equity markets were:⁴

- Materials (+3%)
- Financials (+3%)
- Telecommunications (+2%)

July key laggards

- Health Care (-4%)
- Consumer Staples (-3%)
- Industrials (-2%)

For the year to date, the best-performing sectors in the European Equity markets are:

- Technology (+14%)
- Financials (+12%)
- Industrials (+9%)

For the year to date, key laggards:

- Energy (-9%)
- Real Estate (+2%)
- Consumer Discretionary (+4%)

MSIM European Equities

During the month, in the MS INV European Equity Alpha Fund, we took some profit in U.K. insurance company Prudential, French industrial company Airbus and Dutch semiconductor company ASML. We continued to build up a position in French eye care company Essilor and Spanish IT company Amadeus.

The MS INV 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.

During the month in the MS INV European Equity Alpha Fund, we took some profit in Dutch semiconductor company ASML, German insurance company Allianz, French bank BNP Paribas, French industrial company Airbus and Italian asset management company Azimut. We continued to build up our positions in French eye care company Essilor and Spanish IT company Amadeus.

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

During the month in the MS INV Eurozone Equity Alpha Fund, we topped up our position in Swiss pharmaceutical Novartis and took some profit in Spanish biotech company Grifols and Dutch semiconductor company ASML.

The portfolio remains 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 31 July 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

- Disappointing U.S. growth and legislative progress have driven dollar weakness, despite three rate hikes in the last eight months. Even if the U.S. dollar stabilises from here, it will probably have consequences for earnings in second half of 2017. We believe that a weaker USD should support earnings in the USA while acting as a headwind for European corporates.
- On the other hand, a stronger Euro is likely result in low inflation in the Eurozone, which should push back tightening by the ECB, therefore prolonging the cycle. Historically, each 10% Euro appreciation has caused approximately a 6% fall of Eurozone earning per share (EPS).⁵

- While many companies have FX hedges in place and it is hard to assess their net FX exposure, in general, European sectors with the highest U.S. sales exposure are health care and consumer staples while banks and utilities have very little exposure to USD.

- European banks have delivered yet another strong earning season, with weighted EPS growth 22% ahead of expectations.⁶ Capital goods have been the most disappointing sector, with 20% of companies have missed than beaten earnings.

- EPS growth is now tracking 12.6% growth year-on-year, and we believe a stronger currency will probably slow down the EPS growth pace in the second half of 2017.

- U.S. growth momentum is also slowing down, sending mixed signals: rolling over in credit, housing and car sales. The long-term outlook remains constructive, as Eurozone earnings are still depressed and there is ample potential upside; equities relative valuations are still appealing as government bonds are expensive; equities are still undervalued and liquidity conditions are supportive.

⁴ FactSet, August 2017.

⁵ Credit Suisse Research, August 2017.

⁶ Morgan Stanley Research, August 2017.

Performance in % – Morgan Stanley Investment Funds (MS INVF)

Data as at 31 July 2017.

	1 MONTH	YTD	1 YEAR	3 YEARS ANN.	5 YEARS ANN.	10 YEARS ANN.
MS INVF European Equity Alpha Fund	-1.86	4.99	10.59	4.07	8.19	2.74
MSCI Europe Index	-0.37	6.28	13.54	6.44	10.17	2.65
ALPHA	-1.49	-1.29	-2.95	-2.37	-1.98	0.09
MS INVF Eurozone Equity Alpha Fund	-0.28	7.84	18.08	8.07	12.89	3.46
MSCI EMU Index	0.33	8.80	19.14	8.43	12.58	1.59
ALPHA	-0.61	-0.96	-1.06	-0.36	0.31	1.87
MS INVF European Champions Fund ⁷	-2.39	7.54	5.61	-	-	-
MSCI Europe Index	-0.37	6.28	13.54	-	-	-
ALPHA	-2.02	1.26	-7.93	-	-	-

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.

⁷ Inception date of the Fund is 8th April 2016.

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