

The Markets – A Review

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

In December, MSCI Europe Index finished up 1.5%, bringing the total gain for 2017 to a hefty 25.5%. The market was led by consumer services (+6%), materials (+5%) and real estate (+4%); utilities (-3%), retailing (-3%) and technology (-1%) underperformed.¹

AUTHORS



MATTHEW LEEMAN

*Managing Director
European Equity Team*

Markit's PMI for the euro area's manufacturers rose to a record high in December. Operating conditions continue to improve in all of the eight countries for which separate data is gathered, including Greece (where the manufacturing PMI is at a 114-month high). Once again, the survey highlighted strong growth in output, jobs and new orders.

In early December, Eurostat published estimates of gross domestic product (GDP) growth for 3Q17. Relative to 3Q16, growth is estimated at 2.6%.²

The European Central Bank (ECB) meeting in December ended as expected, with upward revisions to both growth and inflation. Ten-year Bund yields underperformed both treasuries and U.K. gilt, finishing the month five basis points (bps) higher.³

Oil prices continued to rally, making December the fourth consecutive month of price increases. The Brent ended 2017 18% higher.⁴

¹ FactSet, January 2018. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See disclosures for more information.

² Eurostat.

³ Morgan Stanley Research, January 2018.

⁴ MSIM, January 2018.

On the political front, the three pro-Catalan independence parties won a majority of parliamentary seats, but they fell short of a parliament majority. The Italian government has announced that the next election will take place on March 4. The new electoral system is proportional for the most part. The polls say that no single or party coalition is projected to win, and it will likely need support to form a grand coalition to rule the country. In the meanwhile, the Italian economy picked up speed and our economists revised GDP growth numbers upward for 2018.⁵

IN DECEMBER, THE BEST-PERFORMING SECTORS IN THE EUROPEAN EQUITY MARKETS WERE:⁶

- Materials (+5%)
- Real Estate (+4%)
- Energy (+3%)

DECEMBER KEY LAGGARDS WERE:⁶

- Utilities (-3%)
- Technology (+0%)
- Industrials (+1%)

IN 2017, THE BEST-PERFORMING SECTORS IN THE EUROPEAN EQUITY MARKETS WERE:⁶

- Technology (+36%)
- Materials (+35%)
- Industrials (+31%)

2017 KEY LAGGARDS WERE:⁶

- Telecommunications (+16%)
- Health Care (+17%)
- Energy (+20%)

Consider This

European equities and global equities had another strong year in 2017, with the former ending the year up more than 25% (in USD). The key question now is whether it is time to become more bearish in 2018 as the U.S. cycle is nine years old and central bank liquidity will likely turn gradually.

We remain constructive on European equities for the coming months, although we acknowledge that absolute valuations are not as compelling as they used to be and the market might become more cautious for the second half of 2018 when it will likely start to discount the first hike in European interest rates. We want to flag the following supportive points for the coming months:

- European earnings growth for 2018 is positive, with consensus expectations around 6-8% growth.
- GDP growth momentum is likely to continue, with consumer sentiment, unemployment, PMIs and other leading indicators at multi-year highs. The U.K. is the only major country in Europe where our economists predict a strong contraction year-on-year of the economy, but not a recession.
- ECB tightening is not imminent, as our economists expect the first hike only to happen in March 2019.⁷
- Global inflation is on the rise, but it is still well below central banks' targets. Oil prices are up 40% over the past six months, and this will certainly have consequences on inflation over the coming months.

The U.S. curve (10-2 years) is flattening, but it is not inverted yet. The U.S. curve has been a good indicator of future recessions, and when inverted, it has always signalled an imminent recession. Crucially, U.S. stocks never peaked before yield curve inverts.⁸

From a macro perspective, we will carefully watch any potential slowdown in global growth; a significant rise of inflation forcing the Federal Reserve to accelerate the pace of interest rate hikes; political instability (German government; Catalonia; Italian and Swedish elections; Brexit negotiations).

⁵ Morgan Stanley Research, December 2017.

⁶ FactSet, MSCI Europe Index in USD; January 2018.

⁷ Morgan Stanley Research, December 2017.

⁸ JP Morgan Equity Research, S&P 500 Index; December 2017.

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