Morgan Stanley

INVESTMENT MANAGEMENT

2019 Market Outlook

Europe — forever the ugly duckling?

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Despite a strengthening economy, falling unemployment, renewed consumer confidence and increased corporate profits, Europe has fallen out of favour with investors in 2018. In fact, as you can see from the chart in *Display 1*, the pace of outflows has been even greater than in emerging markets, making Europe the most unloved region for equities this year.

Clearly, the macro data for Europe has deteriorated over recent months, mirroring a more general global slowdown as fears over potential trade wars and policy uncertainty have grown. But it is important to understand the context—namely, that the slowdown in lead indicators for Europe has been from near-record high levels. It is unrealistic to expect them to grind ever higher.

In the following outlook, we examine the reasons for investors' disdain for European equities and attempt to ascertain whether Europe is set to remain the perennial ugly duckling or whether there are reasons for optimism for investing in Europe as we look forward to 2019.

European equities: opportunities versus risks

EUROZONE ECONOMY EXPECTED TO GROW STEADILY

We expect the eurozone economy to keep growing around 2.0% annually over the 2018-2020 period, driven by strong economic fundamentals in the private sector and helpful adjustments in the public sector too. Consumers are likely to have more income at their disposal as wage growth pushes income higher and job creation continues to grow apace. Employment in the eurozone hit a new record level in Q2 2018. As the chart illustrates in *Display 2*, unemployment has declined rapidly from 2013 and, contrary to popular belief, is now back to levels last seen before the financial crisis of 2007/2008. This improving trend shows no sign of moderating.

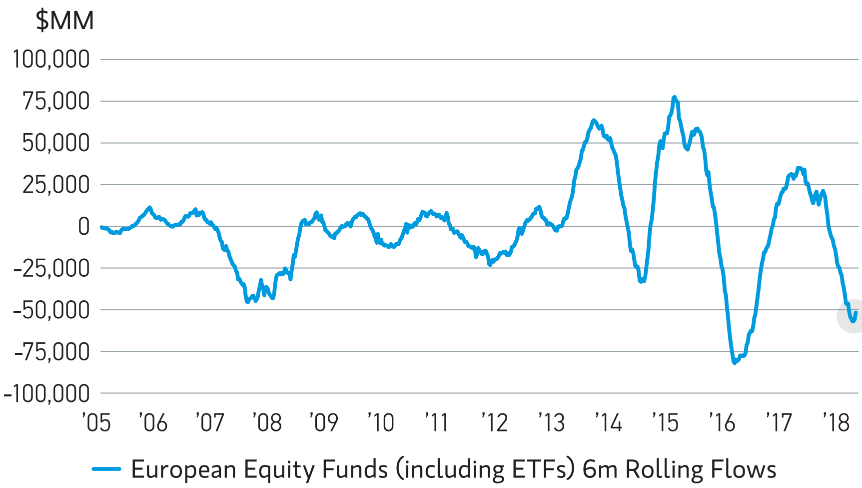
DESPITE TARIFFS, EUROZONE EXPORTS LIKELY TO REMAIN STRONG

European companies are significant exporters in a global context. Since the beginning of the year, the introduction of trade tariffs has been a source of concern for global growth and for the eurozone growth in particular. Nevertheless, worldwide traded volumes have remained quite strong. Machinery goods are one of the main sources of eurozone exports, comprising nearly 40% of exports from the region.[1] However, only 8% of these goods are exported to the U.S. and around 5% to China, so the impact of tariffs alone is likely to be limited.[2] It does not make sense to penalise European exporters

DISPLAY 1

European equities fell out of favour with investors during 2018

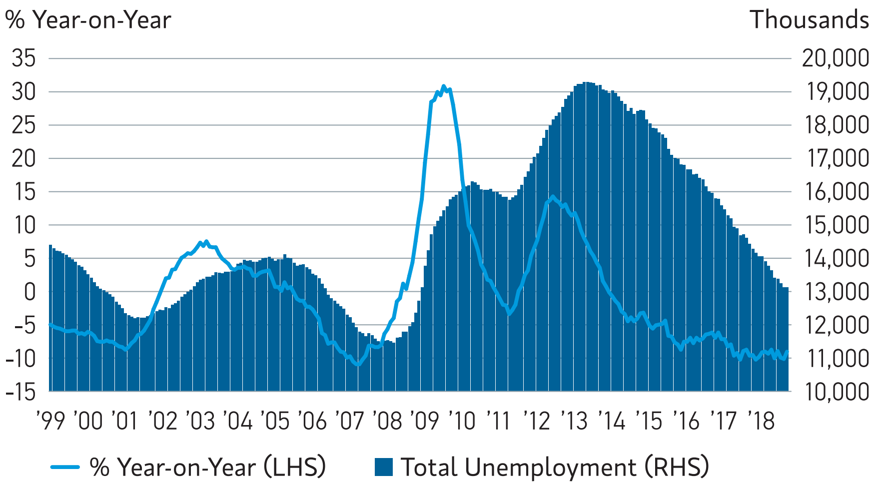
Year-to-Date, as at 1 November 2018: European Funds have seen $50B outflows



Source: Exane BNP Paribas estimates, TIC, EPFR, ICI Mutual Fund Flows: 1 November 2018

DISPLAY 2

Eurozone unemployment trend likely to continue downwards during 2019



Source: Eurostat and Santander: August 2018.

[1] Source: Eurostat and Santander, November 2018
[2] Source: Eurostat and Santander, November 2018

as the major victims of a trade war as continuing recovery in Europe provides a supportive backdrop for European exporters while rising disposable income should also be positive for domestic demand.

EUROPE IS HOME TO MANY WORLD-LEADING COMPANIES

Among all the macro headlines, the fact that Europe is home to many of the world's leading companies is often overlooked. Our approach to investing focuses on companies that have a significant and sustainable competitive advantage. The chart in *Display 3* highlights that over the long run, those companies that have consistently delivered the highest level of profitability have also delivered the strongest share price performance. We are confident that these attributes will continue to be key drivers of stock performance.

EUROZONE COUNTRIES MAINTAIN A CURRENT ACCOUNT SURPLUS

There have been concerns over the state of the EU member states' finances, particularly regarding levels of indebtedness. However, most eurozone countries maintain a current account surplus and, compared to the countries such as the UK, U.S. and Japan, the eurozone has a much lower level of debt/ GDP.[3] Productivity is improving, driven by investment, and margins remain broadly stable. Risks remains — especially where the Italian budget is concerned — but the financial position of nearly all eurozone countries has improved markedly since the financial crisis. It seems unfair to single out Europe in this regard.

EUROZONE INFLATION EXPECTED TO REMAIN BENIGN DURING 2019

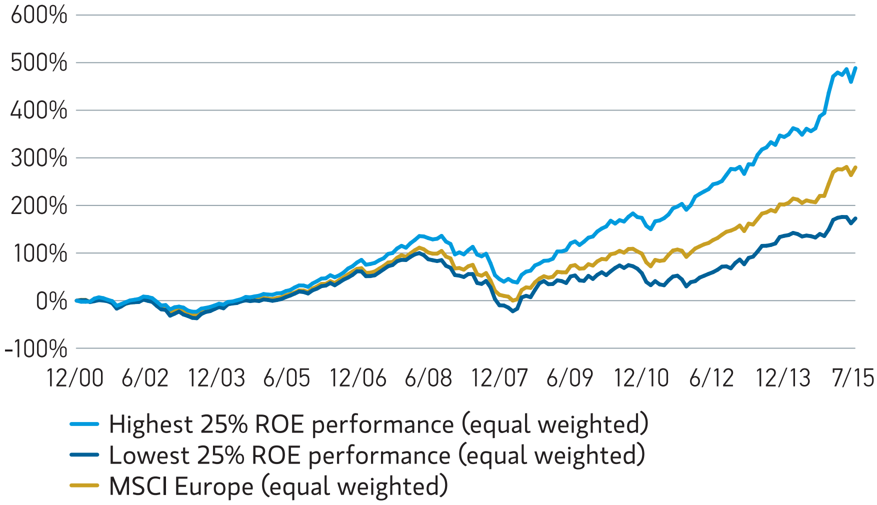
Core inflation has remained muted and below the European Central Bank's (ECB) target of 2% for most of 2018.[4] However, the ECB appears more confident about wage growth[5] and therefore we expect core inflation to rise as we move into 2019[6] (core inflation typically follows wage inflation).
In addition, the ECB assumes more of a fiscal easing for 2019 than was the case earlier in the year, which should also be positive for gross domestic product.

BREXIT: THE ONE WILD CARD

One of the largest shadows of uncertainty hanging over Europe has been that of Brexit. At the time of writing, a deal between the EU and the UK has been reached. However, the effects of any deal are likely to take many quarters, if not years, to become fully evident. Britain's Prime Minister May

DISPLAY 3

Companies with the highest return on investment (ROE) tend to outperform

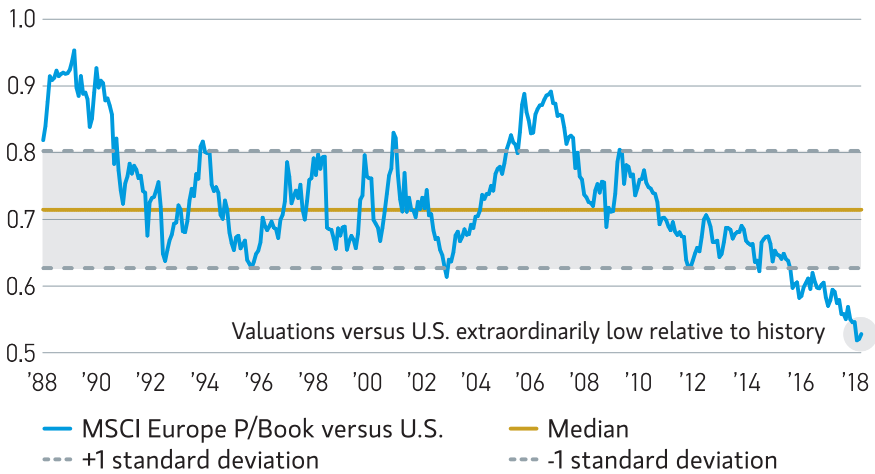


Source: Morgan Stanley Investment Management/Goldman Sachs, August 31, 2015.

DISPLAY 4

Compelling European equity valuations relative to the United States

Europe P/B relative to the U.S. is at 30-year lows



Source: Barclays Research, Datastream, MSCI: 1 November 2018

[3] Source: Exane, November 2018
[4] Source: Santander, November 2018
[5] Source: Jefferies, October 2018
[6] Source: Jefferies, October 2018

faces a Herculean task in persuading the government to support the final outcome in its passage through Parliament. The potential secondary effects here cannot be underestimated as the prime minister has staked her credibility on the agreement with the EU, and her position may prove untenable if she is unable to persuade Parliament to support it. Lurking in the wings is Mr. Corbyn and his increasingly left-wing Labour party with an overt tax, spend and nationalise agenda. We see Brexit uncertainties already reflected to some extent in UK equities and in sterling, and a relief rally in both is possible if Parliament accepts the deal. A change in government is not priced in.

So while headwinds and uncertainties remain, these are not unique to Europe and are likely to be short-lived in nature. Europe, like any region, has its own specific risks (Italian debt, no-deal Brexit), but, on balance, we see a resolution of these issues and progress on other global matters as we move into 2019.

Europe — that ugly duck might just be a beautiful swan

As the chart illustrates in *Display 4*, on the previous page, valuations of European equities are below their long-term average and are especially attractive versus U.S. equities on measures such as price/book, for example.

In our view, this reflects a 'glass half empty' approach by investors. Europe has one of the highest levels of dividend yield at 3.5%, supported by strong free cash flow (FCF) generation. Indeed, the FCF yield is an attractive 6.2%.[7]

The global demand for German cars and machine tools, French luxury goods, Italian fashion, Swiss pharmaceuticals and British financial services remains undimmed. We encourage investors who have no qualms in consuming these goods and services to also examine the companies that make them in order to appreciate the world-class, compelling investment opportunities that exist in Europe beyond the 'ugly duck' headlines.

Risk Considerations

There is no assurance that a Portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the Portfolio will decline and that the value of Portfolio shares may therefore be less than what you paid for them. Accordingly, you can lose money investing in this Portfolio. Please be aware that this Portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market** countries are greater than the risks generally associated with investments in foreign developed countries. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Concentrated investments** in Europe are more susceptible to such risks affecting European issuers than a Portfolio that holds more geographically diversified investments. **Focused Investing.** To the extent that the Portfolio invests in a limited number of issuers, the Portfolio will be more susceptible to negative events affecting those issuers, and a decline in the value of a particular instrument may cause the Portfolio's overall value to decline to a greater degree than if the Portfolio were invested more widely.

[7] Source: Bernstein, November 2018

DEFINITIONS

Free cash flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. FCF represents the cash that a company is able to generate after laying out the money required to maintain or expand its asset base. **Price-to-book ratio (price/book)** compares a stock's market value to the book value per share of total assets less total liabilities. This number is used to judge whether a stock is undervalued or overvalued. **Return on equity (ROE)** is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

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