

## The Markets – A Review

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

The MSCI Europe Index enjoyed another strong month, rising +3.3%<sup>1</sup> in March.

Banks put in a solid performance over the month predominately, driven by the Spanish/Italian names which remain the key beneficiaries of a steeper yield curve.

On the macro economic front, the Euro Area composite PMI came in at its highest level since April 2011 at 56.7 (versus consensus 55.8), whilst German factory orders fell -7.4% (versus consensus -2.5%) and retail sales came in below expectations at 0.1% (versus consensus 0.3%). German industrial production data rebounded, coming in at 2.8% (versus consensus 2.7%), and the ZEW Survey improved month-over-month adding to the series of positive data points.<sup>2</sup> Morgan Stanley economists recently revised upwards their gross domestic product (GDP) forecast for Europe for 2017 to 1.8% and for 2018 to 1.7%

Europe continues to enjoy earnings per share (EPS) upgrade cycle, rising +1% versus an average decline of -5% (to the end of March) over the last 10 years.<sup>3</sup> M&A activity, both intra-Europe and from overseas companies into the region, continues to support the case for Europe.

In the U.K., Prime Minister (PM) Theresa May officially triggered Article 50, kicking off the two-year countdown, whilst Scottish PM Nicola Sturgeon formally called on the government to start negotiations over a second Scottish Independence referendum. More recently, Theresa May announced snap elections for 8<sup>th</sup> June, aiming to capitalise on her significant lead polls currently show. According to her, a more robust majority is necessary to face the complicated negotiations with the European Union.

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<sup>1</sup> FactSet, April 2017.

<sup>2</sup> Morgan Stanley Research, April 2017.

<sup>3</sup> Morgan Stanley Research, April 2017.



Trump's failure to repeal Obamacare certainly caused markets to catch a cold, and markets read this failure as grounds for doubting any swift arrival of fiscal stimulus or tax reform. The result was the end of the S&P's three-month unbroken spell without a 1% daily decline, the longest winning streak in 22 years.<sup>4</sup>

The European Central Bank is unlikely to raise policy rates until 2019, but deposit rates may move higher in coming quarters. Politics present the greatest risk to expansion, with the forthcoming French elections as the next big hurdle.

#### In March the best-performing sectors in the European equity markets were:<sup>5</sup>

- Consumer durables & apparel (+7%)
- Banks (+7%)
- Semiconductors (+6%)

#### March's key laggards:

- Food & staples retailing (0%)
- Real estate (1%)
- Energy (1%)

#### YTD, the best-performing sectors in the European Equity markets are:

- Semiconductors (+14%)
- Consumer durables & apparel (+13%)
- Household & personal products (+12%)

#### YTD key laggards:

- Energy (-4%)
- Retailing (-3%)
- Food & staples retailing (-1%)

### MSIM European Equities

During the month, we continued to reduce our exposure to Spanish IT company Amadeus, taking profits given heightened risk around near-term news flow. We also reduced Irish building material company CRH.

In the European Equity Alpha Strategy, we initiated a position in German chemical company Symrise, a global

leader in flavour and fragrance sector. The sector is highly consolidated with five players dominating the market; it offers very high barriers to entry and exposure to growing trends, such as healthy food and pet food. We believe that Symrise, following a period of acquisitions, is well positioned to deliver superior and consistent cash flow generation, offering an appealing investment opportunity.

Within the European Equity Alpha and Eurozone Equity Alpha Strategies, we initiated a position in German pharmaceutical company Bayer. The company is in the process of integrating American seed and crop company Monsanto, which was acquired in 2016. We believe the combination will create a giant in a much consolidated industry. In addition, Bayer has a solid franchise and pipeline in pharmaceuticals, offering a diversified mix of revenues.

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

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

The European Champions Strategy 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 31 March 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

- European earnings' positive momentum continues, as the combination of macro momentum and euro weakness has boosted profits. This contrasts with the persistent disappointments seen in previous years. The current level of Eurozone PMI, at 56, is consistent with nearly 3% annualised GDP growth and double-digit EPS growth.<sup>6</sup>
- Eurozone equities trade on c.19% PE discount to the U.S., compared to a long run average of c.15%.<sup>7</sup>
- As Trump continues to delay on key campaign promises, a flattening U.S. Treasury curve suggests further downside risks, especially for financials.<sup>8</sup>
- Political risk premium should decline near-term, as markets do not expect a Le Pen victory in the next French election.
- Equities can generally be considered as an inflation hedge while bonds are a deflation hedge. Hence, most of the time inflation rises, equities outperform bonds. In fact, equities reach their highest multiple when inflation is between 0-3%, during which periods the average multiple has been close to 20x. Once inflation accelerates to above 3%, the multiple on equities has generally tended to be lower, especially during periods when inflation ran at levels above 4%.<sup>9</sup>
- As mentioned several times over the past few months, many of the structural headwinds afflicting European equities this cycle have started to abate. Earnings are finally showing signs of life—after seven years of stagnation, with the market consensus forecasting 14% earnings growth in Europe. Valuations, on a relative basis, are still near multi-decade lows and are not pricing in a potential earnings catch up.<sup>10</sup>

<sup>4</sup> Mirabaud Securities, April 2017.

<sup>5</sup> FactSet, April 2017.

<sup>6</sup> JP Morgan Equity Research, April 2017.

<sup>7</sup> Credit Suisse Research, April 2017.

<sup>8</sup> Citigroup Research, April 2017.

<sup>9</sup> Credit Suisse Research, March 2017.

<sup>10</sup> Barclays Research, April 2017.

## Performance – Morgan Stanley Investment Funds (MS INV F)

Data as at 31st March 2017.

	1 MONTH %	YTD %	1 YEAR %	3 YEARS ANN. %	5 YEARS ANN. %	10 YEARS ANN. %
MS INV F European Equity Alpha Fund	3.67	5.32	12.89	4.33	8.62	3.08
MSCI Europe Index	3.34	5.96	16.95	7.18	10.36	2.93
<b>ALPHA</b>	<b>0.33</b>	<b>-0.64</b>	<b>-4.06</b>	<b>-2.85</b>	<b>-1.74</b>	<b>0.15</b>
MS INV F Eurozone Equity Alpha Fund	4.82	6.56	17.16	6.49	12.36	3.59
MSCI EMU Index	5.41	7.11	19.78	7.61	11.43	1.70
<b>ALPHA</b>	<b>-0.59</b>	<b>-0.55</b>	<b>-2.62</b>	<b>-1.12</b>	<b>0.93</b>	<b>1.89</b>
MS INV F European Champions Fund <sup>11</sup>	4.04	8.13	–	–	–	–
MSCI Europe Index	3.34	5.96	–	–	–	–
<b>ALPHA</b>	<b>0.70</b>	<b>2.17</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>

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.

<sup>11</sup> Inception date of the Fund is 8<sup>th</sup> April 2016.

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