Morgan Stanley

INVESTMENT MANAGEMENT

The Markets – A Review

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The MSCI Europe Index gave back -1.1% month-over-month following four consecutive months of positive performance. Financials were the best-performing sector in the index led by diversified financials (+3%) and banks (+2%), while the biggest laggards were food & staples retailing (-6%), retailing (-6%) and energy (-4%).[1]

Following speeches from various central bankers in Sintra (Portugal), there were early signs of the reflation theme being back in the market, driving a rotation into cyclicals. The European Central Bank (ECB) shifted to a more 'hawkish' tone seeing risks to growth as 'balanced' caused the market to refocus on tapering.

In Germany, the Ifo Business Climate reached a new all-time high, printing 115.1 (versus consensus 114.5), Industrial Production expanded while Manufacturing Orders contracted. Macro-economic data in Europe remain positive although the magnitude of improvements has declined.

Crude continued to fall (-4.7% month over month) driven by OPEC meeting failing to meet expectations on production cut and stronger-than-expected production from Libya.[2]

In the U.K., the general election produced a surprise hung parliament, driving conservatives to secure a deal with the Northern Ireland Democratic Unionist Party (DUP) to command a majority.

[1] As represented by the MSCI Europe Index. FactSet, July 2017.

[2] Morgan Stanley Research, July 2017.

The U.K. economy is slowing down, as U.K. industrial production came in at 0.2% (versus consensus 0.7%) and Retail Sales fell by -1.2% (versus consensus 0.8%). U.K. consumer confidence fell sharply and the household saving rate fell to historic lows. The Monetary Policy Committee (MPC) was surprisingly hawkish, with three members voting for a hike.

In Italy, the electoral law reform had a major setback, lowering the probability of an early election this year, and the Eurogroup approved EUR 8.5bn of extra funding for Greece (allowing the country to meet its payment obligations in July). The Greek government has outlined plans to return to the financial markets for the first time since 2014, planning to sell five-year bonds to investors.

In June, the best-performing sectors in the European equity markets were:[3]

- Financials (+2%)
- Materials (0%)
- Industrials (0%)

June key laggards:[3]

- Energy (-4%)
- Telecommunications (-4%)
- Utilities (-3%)

YTD, the best-performing sectors in the European Equity markets are:[3]

- Technology (+21%)
- Industrials (+21%)
- Consumer Staples (+19%)

YTD key laggards:[3]

- Energy (-3%)
- Telecommunications (+10%)
- Materials (+11%)

Consider This

- The recovery is becoming more self-sustaining, as evidenced in the availability of cheap bank loans, a turnaround in construction permits and further tightening in the labor market. Unless this upswing is derailed by political risk (German elections in September), the outlook should remain favorable.[4] In the short-term, we do not exclude a pull-back in the market, given the recent rally and a slowdown in economic activity.
- Earnings per share (EPS) revisions appear to have rolled over in all the key regions, including Europe. Some recent weak Chinese data and mixed U.S. dataflow could affect earnings growth in the second half of 2017. A stronger euro could also be a specific issue for some eurozone exporters, including German exporters, which have done very well since the bottom of the market in 2009.
- A clear disappointment in earnings during the third or fourth quarter will probably be the catalyst to send the market marginally lower, especially given current valuations.
- Recent soft data on inflation allow developed markets' central banks to remove monetary policy accommodation progressively over the course of 2018. Morgan Stanley economists expect the ECB to announce tapering of quantitative easing in September this year, starting from January 2018 and ending in mid-2018.[5] An absence of inflation could also mean that bond yields may remain flattish for the time being. This will have implications on equity sector leadership.

[3] FactSet, July 2017.

[4] Citigroup Global Research, July 2017.

[5] Morgan Stanley Research, June 2017.

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