Morgan Stanley

INVESTMENT MANAGEMENT

The Markets – A Review

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

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MSCI Europe Index finished the month flat at +0.2% in USD. The market was dragged down by health care equipment (-5%), consumer durables (-4%) and retailing (-3%); food & staples retailing (+7%), transportation (+3%) and real estate (+3%) outperformed.[1]

Brexit negotiations continued and, at the beginning of December, the U.K. and the European Union (EU) found an agreement on the first part of the negotiations. They found compromise on the Brexit bill, citizens' rights and the Irish border. With these points now settled, the dialogue can now move to the second stage, which will continue over the coming months. We believe that the U.K. pound and U.K. equities, in particular, will remain volatile depending on the progress of the negotiations.

European macro-economic data remain strong, with manufacturing PMI, industrial production and employment figures continuing their upward trend. Eurozone inflation temporarily slipped and, with oil prices up 40%[2] over the past six months, it will not take long before it returns to the 2% European Central Bank (ECB) target.

The euro outperformed across the board, as the European growth outlook remained positive and the eurozone break-up risk from Catalonia's referendum seemed to reduce. Though initial German coalition talks have fallen through, the markets seem optimistic about some possible return of the grand coalition.

[1] FactSet in USD, December 2017. 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.

Sterling continued to be volatile, as the Bank of England's first hike in November was well priced in by the market. In addition, the government budget failed to impress investors, resulting in some Sterling strengthening when progress on Brexit negotiations were made.

IN NOVEMBER, THE BEST-PERFORMING SECTORS IN THE EUROPEAN EQUITY MARKETS WERE:[2]

- Real estate (+3%)
- Telecommunications (+2%)
- Energy (+1%)

NOVEMBER KEY LAGGARDS:[2]

- Consumer Discretionary (-1%)
- Industrials (-1%)
- Technology (+0%)

FOR THE YEAR TO DATE, THE BEST-PERFORMING SECTORS IN THE EUROPEAN EQUITY MARKETS ARE:[2]

- Technology (+36%)
- Industrials (+30%)
- Materials (+29%)

YEAR-TO-DATE KEY LAGGARDS:[2]

- Telecommunications (+14%)
- Energy (+16%)
- Health Care (+16%)

Consider This

- Global equities have had a strong run year-to-date. Europe, in particular, pending a major sell-off during December, is likely to end the year with an annual performance of around 25% in USD. It is tempting to turn bearish given the big move, the fact that the U.S. cycle is nine years old and that central bank liquidity will be turning. We remain constructive on European equities for the coming months. In particular, we want to highlight our view that:
  - European earnings are set to continue its growth trend.
  - Gross domestic product growth momentum is likely to continue, with consumer sentiment, unemployment, PMIs and other leading indicators at multi-year high. The U.K. is the only major country in Europe where our economists predict a strong contraction of the economy.
  - ECB tightening is not imminent, as our economists expect the first hike to happen only in March 2019.
  - Global inflation is on the rise but 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 eurozone unemployment rate has fully unwound all the downturn caused by the recession, although significant pockets of capacity utilisation rates remain in some parts of southern Europe. This means that wage pressure is not uniform across Europe.
  - Relative valuations of European equities remain undemanding.
- In the U.S., while we acknowledge that the U.S. curve (10-2 years) is flattening, it is still not inverted. The U.S. curve has been a good indicator of future recessions, and when inverted, it has always signalled an imminent recession.
- Geopolitical risks (North Korea, Catalonia, Italian and U.S. mid-term elections, Germany), inflation and U.S. Federal Reserve policy will be key factors to watch in the coming year.

[2] FactSet, MSCI Europe Index in USD; December 2017.

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