Morgan Stanley

INVESTMENT MANAGEMENT

2018 Outlook – Is Goldilocks Set to Continue?

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

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Short of a major collapse in equity markets before the end of the year, 2017 will have proven to be a remarkably sweet spot for investors in European equities as strong, globally synchronized gross domestic product (GDP) growth – coupled with loose monetary policy, benign political framework and record low volatility – has driven stocks remarkably higher.

Inevitably, when the end of the year is approaching, the market and investors start to think about scenarios for the coming year. With the caveat that we have a multi-year time horizon when investing (3-5 years, or even longer), we want to share here our views on European markets for 2018.

In summary, there is no doubt that we saw a strong rally over the past few months and that valuations are not as attractive as they used to be, but we also acknowledge that the market still offers plenty of opportunities for the long-term, patient investor. European equities are still among the most compelling asset classes as U.S. equities and developed government bonds valuations look rich.

As we all know by now, quantitative easing (QE) policies were designed to heal the global economy post the global financial crisis. Now 10 years on from the previous equity market peak, liquidity is about to be withdrawn from the system, and it remains an open question whether the system is sufficiently robust to stand on its own feet without central bank support. We believe that a gradual, well-flagged liquidity reduction should be welcomed by markets in order to help avoid future imbalances in the system. We are less worried about Europe as the European cycle is at a least a few years behind the U.S. one; the European Central Bank (ECB) expects to finish its QE by September 2018, and it will take a few years before it starts to reduce its balance sheet. Hence, we do not expect major repercussions in the European equity market as liquidity will likely still be abundant in the coming months.

With this hurdle cleared, we highlight five factors to support our positive view on European equities for the coming year, or at least for the first half of 2018.

1. Benign macro backdrop

a. Morgan Stanley economists have (again) revised upwards their European GDP forecasts for next year and 2019, following strong recent momentum.[1] European GDP growth expectations for 2019 are now as strong as U.S. ones. More importantly, we welcome the recent breadth of the recovery, with clear evidence of a substantial convergence between growth rates across the region.

2. Easy monetary policy from ECB

a. The ECB seems set to hold an extremely easy monetary policy for the entirety of 2018 at least, with the first hike in interest rates not expected until March 2019.[2] Low inflation allows the ECB (as well as other major Central Banks) to buy time to gradually normalize interest rates.

3. Valuations

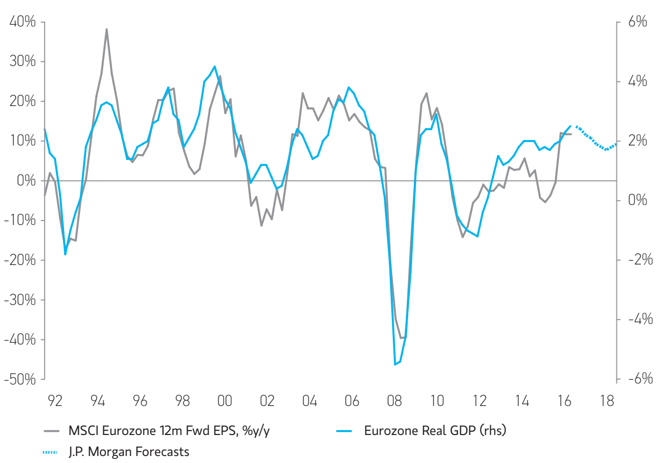
a. Earnings, rather than valuations, have driven the return in 2017: we finally see European profits growing.

4. EPS to continue to grow

a. 2017 should mark the first positive earnings per share (EPS) growth in Europe since 2011. The market consensus is also positive for 2018. In fact, the strengthening of global growth, and a recovery in financials and energy earnings should suggest a positive, albeit slowing, growth also for 2018. European profit margins remain undemanding versus their long-term average.

DISPLAY 1

Eurozone EPS Growth Versus GDP Growth



JP Morgan Equity Research, IBES, November 2017. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

5. Revival of corporate activity

a. The positive political and economic backdrop has helped to restore confidence. The financial system in particular is on a much more solid footing. Banks strengthened their balance sheet and cleaned up non-performing loans (NPLs), reducing the systemic risk. This is very important, as 80% of corporate loans in Europe are still provided by banks (contrary to the USA, where the lion's share is taken by corporate markets).3

What are the risks for the market?

Our positive thesis for 2018 is not without risks. The following factors might destabilise our positive stance for next year:

BREXIT

- U.K. GDP is set to slow in the coming months, and there is uncertainty around Theresa May's ability to strike a successful deal over the coming months, given her slim majority in Parliament and conflicting views around Brexit within her government. We remain firmly underweight U.K. consumer-related stocks in our portfolios.

INVERTING YIELD CURVE

- Premature inverting of U.S. yield curve (10-2 years). The inverting of the curve has always foreshadowed recession in the U.S. While the curve has been flattening, it is not inverted yet. We believe that there is more upside to equities as they have historically tended to peak nine months after the U.S. curve has inverted.[4]

POLITICAL INSTABILITY

- Italy has elections scheduled for the spring of 2018, and the Italian Parliament has just approved a new electoral law. The new law favours mainstream parties over the populist party M5S[5] as coalitions are rewarded, and there is no bonus seat for any party that wins more than 40% of the vote. The mainstream parties are more likely to forge an alliance as the M5S has explicitly ruled out joining any coalition. In Germany, political instability will weigh on the reform timeline, and we would welcome a definitive solution for Catalonia, although it has not been agreed yet.

GLOBAL GROWTH SLOWDOWN

- Significant deceleration in global growth. Europe has a significant exposure to global growth as 60% of European revenues come from abroad; Europe is therefore particularly weak in the event of global economic slowdown.[3]

THE RETURN OF INFLATION

- Rates would need to rise much more than the market is pricing, in order to pose a threat to current equity valuations and corporate profitability. Without significantly higher inflation, it is unlikely that we will have the conditions for a recession in the U.S., and therefore a bear market.

[1] Morgan Stanley, November 2017. Euro area 2018 forecast GDP growth is 2.1% and 1.9% in 2019.

[2] Morgan Stanley European Economists, November 2017.

[3] JP Morgan Equity Research, IBES, November 2017.

[4] JP Morgan Equity Research; November 2017. **Past performance is no guarantee of future results.**

[5] Movimento 5 Stelle, a populist party openly against Europe integration. Current polls for 2018 general elections indicate M5S as the main party at 26-28%. Sources Ipsos, Demopolis and SWG.

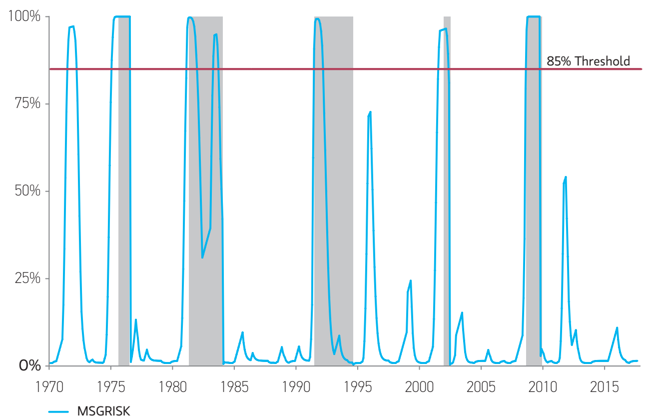
What could further boost markets in 2018?

U.S. tax reform could boost earnings growth in the U.S. as well as some U.S.-related European companies. In addition, further expansion of disruptive business models could keep prices low, reducing wage pressure despite high employment rates (at least in some countries).

In 2018, we will continue to remain focused on our long-term approach of investing in quality companies trading at a reasonable discount to their long-term intrinsic value. Our definition of quality includes companies that are leaders in their field, that generate sustainable and superior profitability and that operate in industries with high barriers to entry.

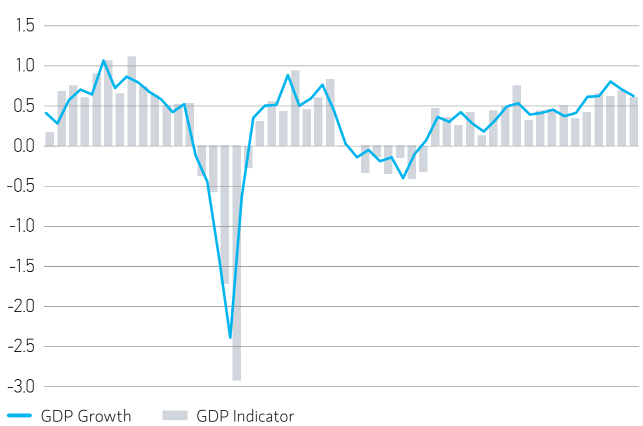
With this final note for the year, we want to thank you for your personal support throughout 2017 and wish you and your families Happy Holidays and a Happy New Year.

Display 2
Global Recession Risk



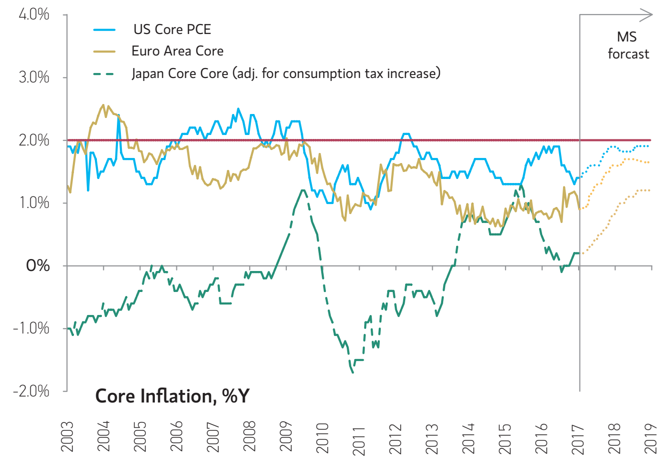
Source: OECD, Morgan Stanley Research. MSGRISK is computed using the algorithm in Chauvet, M and Hamilton, J (2007). Dating Business Cycle Turning Points. MSGRISK signals a imminent recession when it crosses the 85% threshold. A reading near zero corresponds to the unconditional recession probability of 19%.

DISPLAY 3
Strong Near-Term Growth Momentum
Euro Area: GDP Growth and GDP Indicator (%Q)



Source: Eurostat, Morgan Stanley Research forecasts.

DISPLAY 4
Core Inflation to Rise Through 2018, but Still Under Control



Source: Haver analytics, national sources, Morgan Stanley Research forecasts. Note: We are using Core Core inflation for Japan, adjusted for consumption tax.

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DEFINITIONS

Earnings per share is the portion of a company's profit allocated to each outstanding share of common stock.

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