EuroView: Recovery continues and risks recede but how much is left in the tank?
Q3 2017

By Rory Bateman, Head of UK and European Equities

In the last EuroView in January (EuroView: Rotation, earnings recovery and a view from the US), we talked about taking advantage of the inevitable market volatility during periods of political uncertainty. At that time, investors were facing a number of European elections where the rise of peripheral parties seemed destined to wreak havoc on global markets given the potential threat to the EU project.

For those not already invested, the opportunity to "buy the dips" never arose. Centrist politicians cleaned up in France and the Netherlands while the UK's disruptive power was significantly weakened by Theresa May's narrow election victory.

The European equity market gained 18.0% in the year to 30 June 2017 (MSCI Europe, total return). The theme for this review is to advise our clients that, despite the recent strength, we think Europe is likely to continue to perform well against other equity markets. Equities remain attractive relative to other asset classes, in our view.

European equity market mid-year review

The MSCI Europe index delivered a total return of 6.7% in euro terms for the first half of the year. Italy has been the best performing country, up 11.3%, whilst the UK has been the laggard with a return of only 3.0% in euro terms.

The appreciation of the euro versus the US dollar in the first half of the year means that European equities have been one of the best performing global asset classes with a total return of greater than 15% in US dollars, which compares to the S&P 500 at 9.0%.

The substantial outperformance of value versus growth1 in Q4 last year somewhat reversed in 2017 as value underperformed by nearly 5%. Predictably in a rising market, small and mid cap companies outperformed large caps by around 3% in the first half of the year (data source: FactSet as at 30 June 2017).

We have said repeatedly over recent quarters that the "super-tanker" European economy is moving slowly in the right direction and this continues to be our view.

The first section of this review focuses on recent data and forward-looking surveys which suggest 2017 may well prove to be a decent year for growth.

Perhaps unusually, the major risks to Europe appear to be international. In section 2 we look at the main risks to the on-going European recovery and positive market outlook, namely Chinese credit contraction and possible US slowdown.

The remaining sections deal with specific themes including bond yields and inflation, the banking sector, UK & Brexit, valuations and flows.

Europe’s economic performance

The most recent GDP numbers from the eurozone have been strong with year-on-year growth of 1.9%. This was driven during the first quarter of this year by fixed investment and household consumption. The outlook

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1 Growth stocks are those whose earnings are expected to grow at an above-average rate relative to the market. Value stocks tend to trade at a lower price relative to fundamentals (e.g. dividends, earnings and sales).
for Q2 also looks positive. The chart below illustrates the slow growth trajectory that Europe has experienced since the 2013 trough.

**Chart 1: Eurozone GDP growth**

![Eurozone GDP growth chart](source: Thomson DataStream, July 2017)

Forward-looking surveys such as industrial and services confidence and purchasing managers’ indices (PMIs) are all pointing in the right direction, implying growth for 2017 is on track.

**Chart 2: Eurozone industrial and services confidence**

![Eurozone industrial and services confidence chart](source: Thomson DataStream, July 2017)

**Risks ahead - Chinese credit contraction and US slowdown**

In isolation, the gradual recovery continues in Europe and we expect that to continue. However, international conditions need to remain benign and this cannot be taken for granted. There is mounting evidence that China is restricting credit growth through a tightening of the money supply. Meanwhile other major central banks are indicating a progressive tapering of their extremely loose monetary policies.
The chart below shows M2\(^2\) money supply growth in China at 9.6% which is the lowest rate on record and indicative of the slowing credit environment. That said, overall monetary conditions appear to have stabilised after falling sharply earlier this year.

**Chart 3: M2 money supply growth in China**

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In the US the data surprise index has been surprisingly weak, raising concerns that President Trump is simply unable to deliver on his stimulative agenda.

Initially, his promises to cut tax, increase infrastructure spending and deregulate industry and banking were music to the ears of investors in US companies. Investors piled in to sectors that were set to benefit from Trump's agenda, like energy, banks and some technology stocks.

However, as time has passed, investors have lost some faith in the president's ability to deliver on his promises. The clumsy and combative nature of the administration has seen delays to the reforms promised to the Affordable Care Act, which in turn has delayed progress on budget reforms in the House.

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\(^2\) M2 is a measure of broad money supply in an economy. It includes cash and checking deposits but also assets that can be quickly converted into cash such as savings deposits, money market securities and mutual funds.
Recent payroll data would suggest the US economy continues to perform but this is typically a backward-looking indicator in terms of stockmarket performance. Our concern is over the sustainability of market levels if there is not continued improvement in corporate earnings.

Given the market rating and extended profitability of US companies, we find it difficult to see significant upside from here. However, a stabilisation in the US is consistent with a modestly rising European market given the different starting points.

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**Chart 4: US economic data has been weaker than expected**

Citi group economic surprise index (CESI) US


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**Chart 5: Europe remains attractively valued while US looks stretched**

Cyclically-adjusted P/E of global regions

Source: Thomson DataStream, 30 June 2017. Regions shown are for illustrative purposes only and should not be viewed as a recommendation to buy or sell.

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³ The cyclically-adjusted price-to-earnings ratio, or CAPE, is a valuation measure. It defined as price divided by the average of ten years of earnings, adjusted for inflation.
Bond yields and inflation

Despite the very recent uptick in yields, tightening monetary conditions and possible peak lead indicators are being reflected in bond markets with 10-year Treasuries around 2.3% and German Bunds at around 0.55%. Chart 6 below shows the market’s estimate of inflation in five years’ time five years from now.

This indicates inflation at 1.6% in Europe, still below target even after the extensive quantitative easing (QE) programme we have witnessed in recent years.

Chart 6: Inflation in Europe still below target

Source: Thomson DataStream, 30 June 2017.

There is little wage growth despite employment numbers rising across the developed world - the Phillips Curve⁴ is not working!

What is clear is that overall productivity is not improving and working practises are changing. Decreased unionisation, more casual workers, zero-hours contracts and increased self-employed all point towards less wage pressure which is required to stimulate underlying inflation.

If we combine monetary tightening with lower oil prices and sluggish wage growth, the outlook for a pick up in inflationary expectations will be muted. This has ramifications for progressive sales growth across many sectors in the market.

The recent pick up in yields is more a reflection that the central banks are now acknowledging that tapering of their monetary policies has moved up the agenda.

Improvements in the banking sector

The pan-European banking sector has been improving for some time with capital levels and bank profitability continuing to build. Regulatory headwinds are abating and geopolitical risks feel diminished.

On a more cautionary note, the reflation⁵ trade that has turned sentiment towards the sector over the past year could abate should higher rate expectations get pushed out.

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⁴ The Phillips curve describes a historical inverse relationship between rates of unemployment and corresponding rates of inflation. It states that lower unemployment in an economy will correlate with higher rates of inflation.
Within the euro area, core inflation is subdued and wage growth is muted despite strengthening GDP and falling unemployment. The risk therefore is that interest rates remain at extremely low levels even as the economy strengthens and the sector fails to benefit from higher rates.

From a capital adequacy perspective, the banking sector is far from uniform. The majority of banks have now rebuilt capital to levels which incorporate a reasonable buffer against the unexpected. However, the capacity of banks to continue to build capital - and so fund growth, pay dividends, absorb unanticipated shocks and accommodate regulatory pressure - varies markedly.

In the UK, the equity market seems to be applying an ever-higher risk premium to UK domestic banks. A weakened government, slackening GDP, high consumer indebtedness and Brexit-related uncertainties present an unpalatable cocktail of concerns.

That said we now believe domestic UK banks screen comfortably at the cheaper end of the spectrum. We see a high chance that patience could be well-rewarded in selected names.

For further information on the banking sector, please see our recent note European banks: why investors should still be choosy even as prospects brighten

**The UK and Brexit**

In the UK, politics and policy have been centre stage for investors of late. UK investors will seek to calibrate the effect on stocks and markets of changing perceptions about the government’s policy positions.

In this respect, the consequences of any loosening of the public spending “purse strings” require attention. So too do the Conservatives’ shifting policy priorities as they respond to the new reality of minority government. Although another general election does not look imminent, investors will now need to understand better the likely policies of any potential Labour government.

As regards Brexit, we expect many twists and turns over coming months. Our approach regarding this and politics generally will be to respond pragmatically to any market turbulence.

As significant as the domestic issues undoubtedly are, our sense is that the wider global backdrop will be a potentially greater driver of UK equities and other markets. In this context, asset markets have been driven up by a widely held belief in a “Goldilocks” global economy which has been “not too hot, not too cold” with moderate growth, low inflation and supportive monetary policy.

The durability of this narrative will determine the progress of UK equities. Any challenge to these preconditions is likely to cause market volatility. There is evidence recently that investors have been unsettled by even slightly hawkish comments from policymakers and the China/US concerns discussed above are very legitimate.

**Valuations and fund flows**

Following Emmanuel Macron’s victory in the French elections, there has been a pick up in flows into Europe. However, they remain low, particularly compared to the US. The chart overleaf shows cumulative exchange traded fund (ETF) flows into Europe and the US over the last 15 months. There remains a massive $260 billion difference between the two regions which, given the valuation differential and uncertainties in the US, may well unwind.

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5 Reflation is a fiscal or monetary policy designed to expand a country’s output, seeking to bring the economy back up to the long-term trend after periods of stagnation or contraction.
Growth has outperformed value by 5% this year. This is a reversal of the gains we saw in the final quarter last year where value stocks performed well particularly during the Trump “reflation trade”.

Value stocks have tracked back along with bond yields so far this year, although the recent spike in yields may suggest more confidence around economic growth or perhaps fears of QE tapering. Higher conviction in future growth would be beneficial for value stocks given greater certainty around cyclical earnings. Chart 8 shows the relative performance of growth versus value going back to 2007.
Europe has seen positive earnings revisions over recent months, as chart 9 above indicates. These have been delivered through a combination of better corporate pricing power and ongoing operational leverage as spare capacity in the economy is utilised.

However, the recent decline in inflation expectations suggests the top-line pricing momentum may be difficult to continue. Therefore while we expect a good earnings performance this year - or around mid-teens earnings growth - it is unlikely that we see a dramatic shift in earnings expectations from here.

Having said that, the absolute level of earnings in Europe is still very low. Chart 10 below shows US and European net profit margins.

**Chart 9: Earnings revisions in Europe have turned positive**

![Chart 9](image)

Source: Bank of America Merrill Lynch, 30 June 2017

**Chart 10: Profit margins in Europe lag the US**

![Chart 10](image)

Source: Thomson DataStream, 30 June 2017. Chart shows trailing 12-month net profit margins.
Europe remains a recovery story and we think there is much further to go. Chart 11 shows how the pan-European index MSCI Europe has lagged the US S&P 500 since the global financial crisis. Meanwhile, chart 12 indicates how average valuations in Europe are still below US levels.

**Chart 11: Europe is still a recovery story**

Source: Thomson Datastream, 30 June 2017. Past performance is not a guide to future performance and may not be repeated.

**Chart 12: European valuations still lag the US**

Price-to-earnings ratio

Source: Thomson DataStream, 30 June 2017

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