Outlook on **Europe**

JAN
2016

Summary

- European economic data continues to be relatively robust; the European Union's third-quarter GDP rose 1.9% year-on-year and the unemployment rate has fallen to its lowest level in more than six years.
- The biggest concern in Europe relates to the political landscape. The surge in populist politics, the ongoing terrorist threat, and the immigrant crises create an extremely uncertain environment for political outcomes.
- We expect sentiment towards bonds of the European periphery will remain positive in 2016, as the "hunt for yield" is still strong in this low yield environment.
- Strong government bond buying as a result of the ECB's newly extended QE program should limit increases in government bond yields and spreads.

European Equities

"Every breaking wave on the shore tells the next one that there will be one more..."

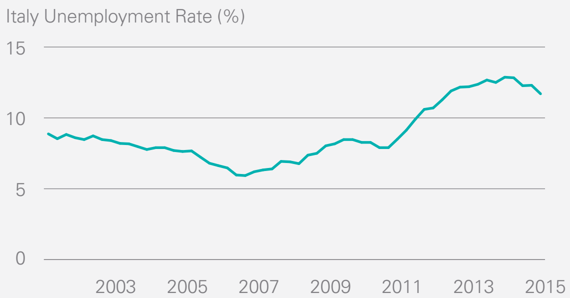
Every Breaking Wave, Songs of Innocence, U2, 2015

It is highly unlikely that U2 were referring to equity market movements in this lyric, but it happens to nicely describe consensus thinking about the market conundrum facing us today. Equity investors tend to use history as a guide to the future and as it has been over six years since the bottom of the last significant market cycle, many have started to worry about where markets are positioned, with some market watchers positing that we may be nearing the end of the global growth period and headed back into recession. Given the increasing uncertainty in the macroeconomic environment, particularly in the United States and emerging markets, that concern is understandable. However, there is no historical precedent for many of today's market conditions; for instance, the European Central Bank's (ECB's) quantitative easing (QE) or negative interest rates in German bonds as far out as seven years to maturity. As such, we fear that current circumstances render investment approaches that emphasise, or even rely on, history repeating itself vulnerable to significant error. We therefore prefer to focus on the profits and potential of individual companies in order to form our investment strategy and, using this approach, in Europe we find a slightly more optimistic outlook than the rest of the world.

Europe's economic backdrop has become relatively robust. Total third-quarter 2015 GDP for the 28 economies of the European Union (EU) was up 1.9% year-on-year and the unemployment rate has fallen to 9.3%, the lowest level in more than six years. The unemployment level in Italy has been stubbornly high for the past few years, but has been improving since September 2014 (Exhibit 1). According to Italy's national statistics office, it fell to 11.3% in November, its lowest level in three years, with the number of unemployed dropping by nearly 500,000 year-on-year.

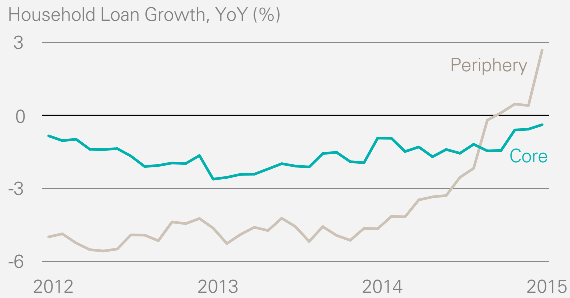
An indication of increasing household activity is household loans, and this has become increasingly positive, particularly in the periphery (Exhibit 2).

Exhibit 1
Italy's Stubbornly High Unemployment Rate Has Recently Improved



As of 30 September 2015
Source: Bloomberg

Exhibit 2
Better European Household Loan Activity



As of 31 October 2015
Excludes house purchase loans.
Source: Autonomous

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In contrast, economic data for most of the rest of the world has become more unstable, including in the United States, where recent survey data has been disturbing. For instance, the Institute of Supply Management's Purchasing Managers' Index recorded a 48.2% reading in December, implying a small contraction in US industrial demand. That volatility becomes even more pertinent when one considers the fact that the US Federal Reserve recently marked the end of its seven-year experiment with near-zero interest rates by raising the range of its target benchmark rate by a quarter-point to between 0.25% and 0.5%, and has pledged a series of gradual increases over the next few quarters. However, we think it is important to put the US rate rise into perspective; rates have not been at this low level before, and so we feel there is no basis for comparison to past rate hike cycles. In other words, we believe it highly unlikely that this is the start of a significant tightening of liquidity in the United States or global economy.

To be clear, European growth would not be able to withstand a US or global recession if that were to happen; however, Europe's recovery appears to have sufficient domestic traction that it is not reliant on the United States or even emerging markets to sustain its current growth profile.

As the United States has raised rates, Europe has gone deeper into negative territory. Twelve of the thirteen countries with negative yields in international debt markets are European. Additionally, at its December 3 meeting, the ECB lowered its deposit rate by a further 0.1 percentage point to -0.3% and extended its QE programme until at least March 2017. However, the ECB's monetary stimulus was not as large as the market expected, possibly due to signs of a nascent rebound in Europe.

The price of oil has more than halved since June 2014 and is now trading at an eleven-year low of below $36 a barrel, causing increased scrutiny by banks into loans made to oil- and gas-reliant businesses. While this could be a negative for some banks and oil companies, overall, Europe stands to continue to benefit from low oil prices as it is a significant net importer of fuel. These disinflationary benefits in 2016 may be hard to interpret as inflation borders on deflation in some areas; however, we believe that the overall impact is positive as European consumers benefit from lower petrol and manufacturing costs, which facilitates investment and job creation and boosts discretionary incomes. This, in turn, may influence the timing of any interest rate increase in Europe, although at the current time this seems a long way off. Europe's promising economic backdrop means that all in all, we are expecting Europe to continue its rehabilitation in 2016.

The December corporate earnings season was, as many expected, very poor with weakness in emerging markets currencies partially responsible for downgrades. Some emerging markets currencies noticeably rebounded in the fourth quarter, suggesting that currency weakness may pose less of a headwind going forward provided this trend is sustainable. Another factor that depressed market returns going into year-end was the ECB's monetary policy decision in December.

The improved domestic picture for European profits has meant that, from a portfolio perspective, in 2015 we have become more domestically exposed. Looking forward, we find that there is a much wider set of opportunities in both international and domestic companies as the uncertainties in emerging markets have created some significant share price declines, while the improving underlying data in some domestic European markets continues to surprise investors positively.

We believe the biggest concern in Europe relates to the political landscape. The surge in populist politics, combined with the ongoing terrorist threat, and the immigrant crises, which saw more than a million migrants seek refuge in Europe in 2015 (a fourfold increase from 2014 according to the International Organisation for Migration), creates an extremely uncertain environment for political outcomes. This could cause some short-term volatility and, longer term, even raise the discount rate a little. However, we think it is important to bear in mind that, ultimately, it is company profits that drive share prices and the majority of companies will not be significantly impacted by any political outcome in Europe. Additionally, although we expect market uncertainty and volatility in the lead-up to the referendum on the United Kingdom's potential secession from Europe, the date of which is as yet uncertain, history tells us that until we get within a few months of the referendum the market will be unlikely to price in this scenario.

In conclusion, very low to negative interest rates across the short- to medium-term yield curve puts the value of other assets into perspective, and in this context European equities continue to represent good value. This, coupled with lower commodity prices and an improving underlying economic environment should, we feel, make Europe stand out in a global context.

Therefore, despite the uncertainties of the European political and global macroeconomic environment, we remain positive in our outlook for European equities, particularly given the backdrop of other asset prices and global equity valuations.

In light of these anomalous market conditions, we continue to believe that focusing on the unique challenges and opportunities of each individual investment is the most effective way of cutting through the static. For stock pickers focused on the right fundamentals this can translate into an opportunity to establish positions in attractively valued companies.

European Fixed Income

European fixed income markets continued to rebound from their strong sell-off in the second quarter of 2015, extending their third-quarter recovery to the fourth quarter. The markets' central bank dependence became even more pronounced, as market participants were focused on the policy divergence between the European Central Bank and the US Federal Reserve in the wake of the important ECB decision on December 3 and Fed decision on December 16. Both central banks are committed to following different monetary policies throughout 2016. While the Fed plans to tighten US monetary policy with several rate hikes in 2016, the ECB has opted to continue its quantitative easing programme until at least March 2017. Yields on 10-year Bunds were volatile during the year compared to their Japanese and Swiss government bond counterparts (Exhibit 3). They began 2015 at 0.54% and fell to 0.08% on April 17, subsequently climbing to 1.00% on June 10 and eventually ended the year at 0.63%.

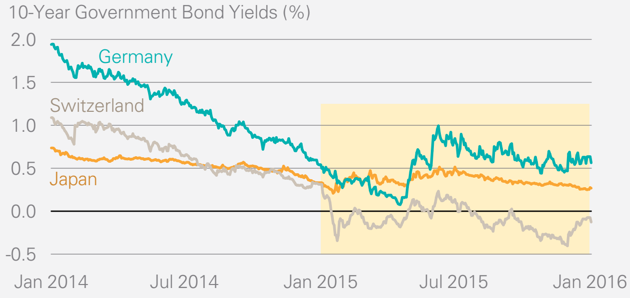
We see good reasons for these different central bank policies. The US expansion is well established and its labour market has tightened, while the euro zone economy is fragile, its labour market is still in relatively bad shape (especially in France and Italy, Exhibit 4), and there are disinflationary pressures arising from Europe's stronger emerging markets exposure and greater sensitivity to lower oil and commodity prices compared to the United States or emerging markets.

Despite the US rate hike fears, bonds and credit markets remained in "risk on" mode, very much in contrast to markets for commodities and many emerging markets assets, which extended the weakness they have displayed over the past few months. In the European fixed income arena, bonds of the European periphery outperformed quite strongly, buoyed by the extension of the ECB's QE programme. The euro weakened throughout the fourth quarter, but began to appreciate after the ECB's meeting in December, climbing 3% against the dollar the day the ECB announced the extension to its bond-buying programme.

Uncertainty remains high, fuelled by the lack of transparency of Chinese economic data, the ongoing crisis of commodities and emerging markets, nervousness about the Fed outlook, and the great divergence in international monetary policy. Additionally, most of the world is still characterised by very low inflation expectations (Exhibit 5).

For Europe, we expect lacklustre, but stable growth of about 1.5%–2.0% over the next few quarters and ongoing low inflation, aside from negative base effects from the oil price collapse that started in June 2014 is gradually fading, as suggested by the annual change in the headline consumer price index. The ECB still views itself as a backstop for the markets in turbulent times, as the structural problems of the euro zone are not yet solved. There is expected to be strong government bond buying as a result of the ECB's QE programme, which should limit any increase in government bond yields and spreads. An improved outlook for Greece, Portugal, Spain, and Italy and pressure from the ECB should keep government bond markets in the European periphery in good shape and allow further spread tightening (Exhibit 6). We believe the US bond market is a major risk factor for European bonds, as the spread between US and German 10-year government bonds has already widened to very high levels making further outperformance of the European market quite difficult.

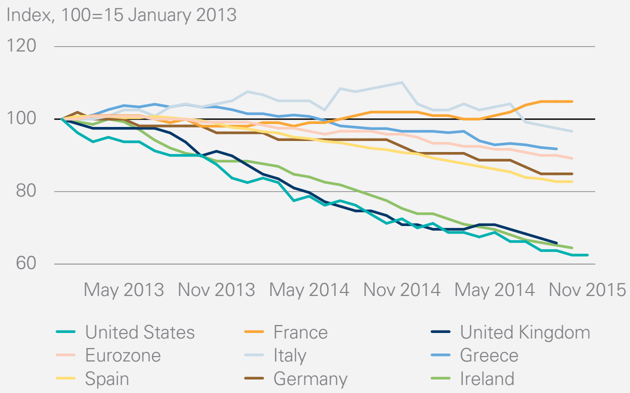
Exhibit 3
Bund Yields Rose in 2015



As of 5 January 2016
The performance quoted represents past performance. Past performance does not guarantee future results.
Source: Thomson Reuters Datastream.

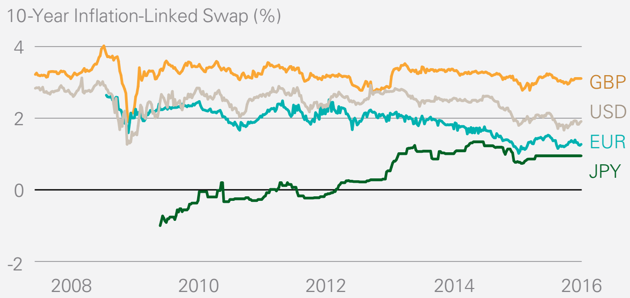
Exhibit 4
Unemployment has not Declined as Strongly in Europe as in the United States

Unemployment Level



As of 13 November 2015
Source: Thomson Reuters Datastream

Exhibit 5
Inflation Expectations Globally Are Generally Low

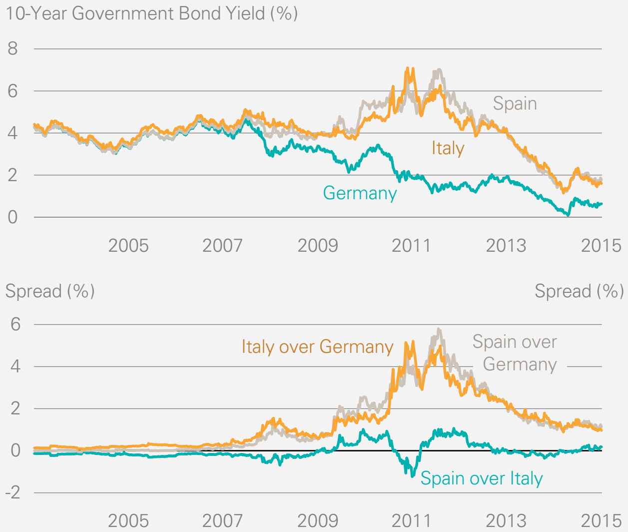


As of 5 January 2016
The performance quoted represents past performance. Past performance does not guarantee future results.
Source: Thomson Reuters Datastream

We expect European core government bond yields to return to a tighter range and expect 10-year Bunds to trade in a yield band between 0.25% and 1.00% for quite some time. We expect sentiment towards bonds of the European periphery will remain positive in 2016, as the "hunt for yield" is still strong in this low yield environment.

European corporate bond spreads have stabilised after a dramatic spread widening in September and may remain quite stable around their current levels. In the wake of the sell-off, selective buying opportunities arose in some sectors, for example the energy sector, due to weakness in commodity markets. The demand for higher returns should be enough to earn the carry of spread products and allow for some moderate tightening. Due to the risks to European bond returns posed by US monetary policy, we remain cautiously positioned with respect to duration but are flexible enough to swiftly change course, as sentiment can turn very abruptly.

Exhibit 6
Italian and Spanish Spreads to German Bunds Have Tightened



As of 31 December 2015
Past performance is not a reliable indicator of future results.
Source: Thomson Reuters Datastream

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