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Three themes for European equities to be back in focus

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"A stabilisation of the economic outlook and a reduction of political risks after the elections could bode well for European equities".

- ***Volatility is here to stay.*** *Markets are hostages of very volatile news flow. Trade-related anxiety is driving the swing (pessimism of a broken deal between China and US led to a correction in May while the renewed hope of a partial deal brought equity markets back to yearly highs in June). More recently, the ultra-dovish tone of major Central Banks added to the optimism, signalling the commitment to extend the current cycle, amid a deceleration of global growth and a not brilliant earnings outlook. Against this backdrop of uncertainty* ***we expect global equities to remain in a trading range, pointing to the need for investors to focus more on relative value opportunities across regions*** *and names to extract value rather than betting on strong directional calls.*
- ***On a regional basis, we believe there is room for European equities to be among the outperformers in the global equity space*** *and provide fertile ground for investors in search of opportunities. For global investors,* ***having a bearish positioning on Europe****, we think it is now time to reconsider the allocation to this asset class, especially on a relative basis on the back of* ***three main themes****.*
- ***Theme 1. Europe could benefit from a stabilisation in the economic outlook, European Central Bank (ECB) accommodative stance and fading political risks.*** *Moderate growth to continue, sustained by a decent domestic demand, even if risks are tilted to the downside, and they are strictly connected to the geopolitical situation (trade war evolution). The possibility for the ECB to further add stimulus is another supporting element, preventing an unwanted Euro currency appreciation and reinforcing the shield against a deterioration of the global economic picture.*
- ***Theme 2. Converging earnings growth vs. the rest of the world and fair valuations*** *make Europe more investable than the positioning of investors suggests.*
- ***Theme 3.*** *With a medium to long-term view* ***European equities also remain attractive*** *for Euro based investors* ***in search for yield and*** *for investors with a* ***focus on ESG themes.***

Theme 1. Stabilisation in the economic oultook and fading political risks

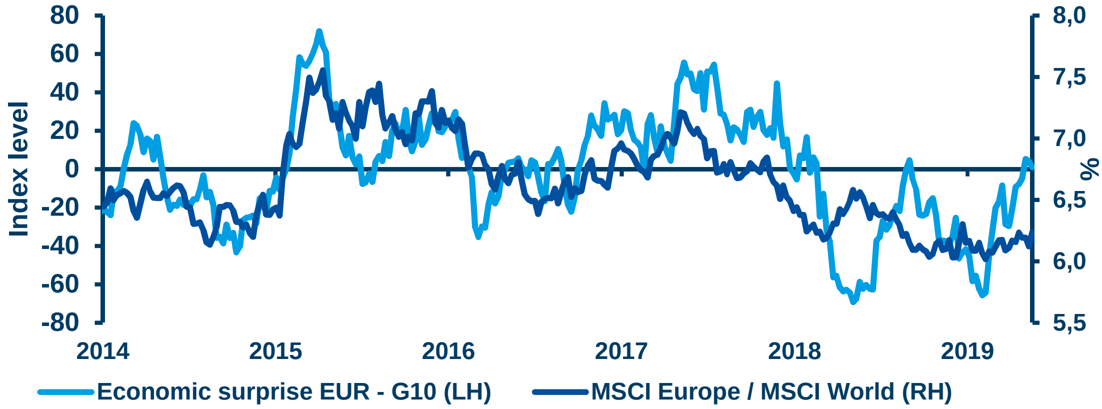
Uncertainty persists with the trade war still making the headlines. Fresh positive news on the economic side is needed to support stock markets as the up-trend phase cannot last for longer without the macro support. Where is Europe going from here?

1. **Stabilisation of growth outlook.** Overall, economic surprises have recently become much less negative than at the beginning of 2019, despite persistent pressures on manufacturing sentiment indices. The growth outlook will remain positive, although not as strong as in Q1. Nonetheless we expect most other economic metrics to improve gradually due to different factors. First and foremost, **cyclical variables** (especially employment and wages) remain on a positive trend. Moreover, the fiscal stance in the four largest countries is **easing** (for an estimated total of 0.5% of Eurozone GDP). Gains in household real disposable income will be a very supportive factor in 2019, also helped by the recent decline in oil prices. Moreover, the **ECB remains very dovish:** further measures are expected to stabilise inflation expectations and attempt to reach the inflation target.
   On the other side, there are risks to monitor, especially linked to the prolonged weakness in global trade and manufacturing which could ultimately change the corporate attitude towards hiring. Also, a rise in households' precautionary savings could erase the effect of the positive factors mentioned above. A *no-deal Brexit* and potential new US tariffs on European goods are also major risks to watch.
   However, all in all, **we believe that the recent pessimism on European economy is overdone.**

2. **Reduction of political risks in Europe**. In autumn there could be more visibility on the Brexit evolution, and the new equilibria following the European elections will slowly materialise. What came out from the elections was a still strong pro-European bloc, with a contained advancement of populist or euro-critical forces (mainly in Italy and in France) that, however, will contribute to keep the political factor in focus. Progress in the China – US deal could certainly help in creating a more favourable environment for stocks. We still see a limited consensus in the US for a tariff increase against Europe, and the already decelerating US economy could curb President Trump to move aggressively.

As the European equity market is highly linked to the global cycle (European companies derive more than half of their revenues from outside Europe), the view that EU equities could outperform in relative terms is based on the fact that our central scenario (deceleration of the US economy to its potential combined with some stimulating measures in China, no further escalation of the trade war and strong domestic demand) is confirmed. For European equities to outperform, it is important that the economic outlook improves vs the other G10. From the chart below, the relative EU market performance tends to move together with the economic surprise index differential, which recently has started to move in favour of Europe.

Economic surprise index and EU equity relative performance



Source: Amundi, Bloomberg, as of 21 May 2019. CitiEconomic surprise index EU vs G10 differantial and MSCI Europe vs MSCI World.

"Despite a possible mid-term uptrend for the Euro, we do not see the Euro appreciating in the short-term as far as uncertainty and ultra-dovish ECB persist".

A possible tailwind could eventually come from the Euro, but there is room before this materialises. The fair value of the EUR/USD is around 1.20-1.25, which means that current level (at 1.12) is positive for European companies' profitability. A more accommodative ECB should also prevent the Euro currency appreciating.

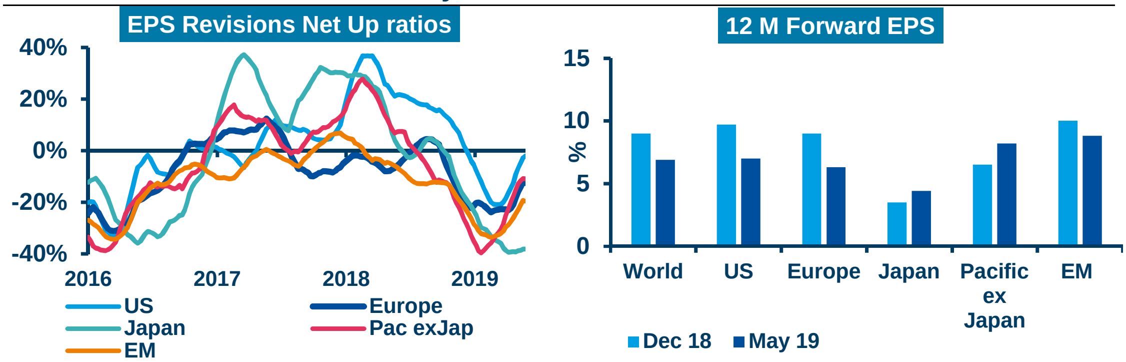
Indeed, the US economy is slowing from a strong base (2.4% in 2019, 2.0% in 2020), while the EMU economy is expected to gradually peak up from a low base (1.0% in 2019, 1.5% in 2020); the combination of the two is in favour of a stronger Euro on the mid-term. This also means that in terms of direction, the mid-term perspective for the Euro is rather up. In the short term however, the risk aversion linked to political factor in Europe (decreased but still present) more complicated final negotiations for China-US trade deal and ECB ultra-dovishness are providing some support to the USD.
In-between, if flows to European equities have been negative for some time, any revival of interest could eventually attract foreign investors without the necessity to hedge the currency.

Theme 2. Earnings outlook and valuations supportive for a relative call

Earnings are due to grow to a low single digit in the next 12 months according to the Ibes consensus, in sync with earnings growth of the rest of the world.

"With bottoming out earnings revisions and expected earnings growth in line with the rest of Developed Markets there is not a case for being short European Equities vs the overall market".

EPS Outlook: in line with a late cycle feature and not worse than other



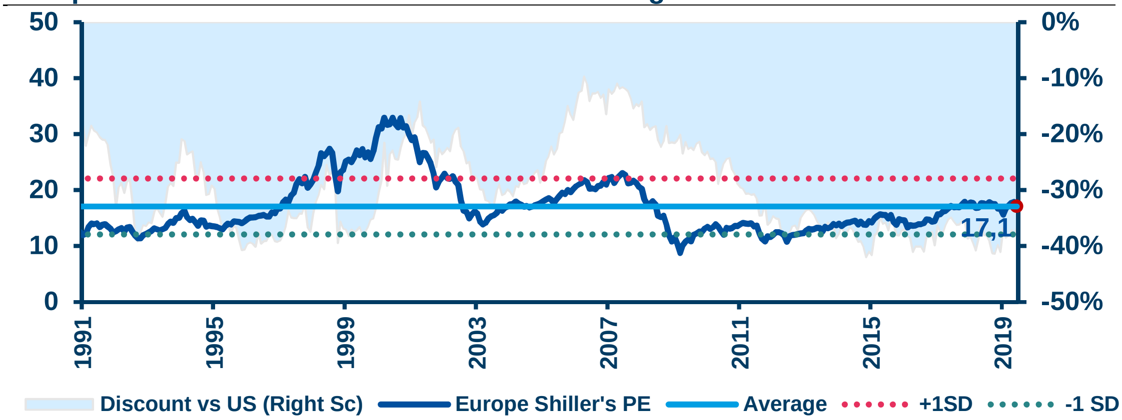
Source: Amundi Research. Chart on the left is the net revision ratio (3 months moving average) IBES consensus, EPS in local currencies for distinct countries, as of 18 May 2019.

Even if this forecast should be considered as a top of the range, this convergence is a clear feature of a late cycle environment.
European profits have been lagging the ones of the other regions since the top of the previous cycle. They succeeded to rise twice since 2009, from early 2010 to mid-2011, and from early 2017 to spring 2018. The last rebound has been stronger than for other regions. But since then, they have disappointed again. **The first quarter this year could mark the bottom of this phase**. According to our internal model, based on the behaviour of the CRB industrials (indicator of the global industrial commodity market), Emerging Markets, US earnings, the Euro currency and business survey indicators, earnings growth should be able to stay slightly positive for the next 6 months and aligned to the World Index.

"Valuations are in line with historical average, but attractive compared to the US".

In terms of valuations, **Europe looks relatively cheap according to different valuation parameters.** The Shiller PE (price earnings ratio is based on average inflation-adjusted earnings from the previous 10 years) for example shows a discount to the US close to all-time lows (-37%). Using the 12 months Price Earnings Ratio (which uses projected earnings for the next 12 months), European valuations are also cheap vs the MSCI World, and below the long-term average, even if not in oversold territory.

European valuations in line with historical average but discounted vs US

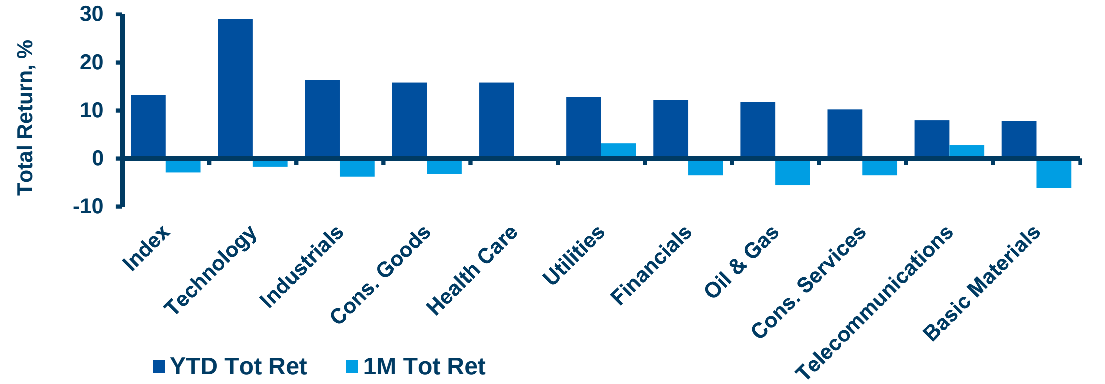


Source: Amundi Research, Datastream Data as of 21 May 2019.

In terms of selection, we believe that it is possible to identify even more opportunities among **the cyclical compartments vs the more defensive ones which in our view have become too expensive**. The performance driver here on is less about major shifts in earnings outlook and more about implied expectations being too negative.
We like, for example, high quality industrials with strong balance sheets. Some of these trade at levels that imply excessively negative outlook.

For the braves there is also a lot of **value in some of the European banks** which suffered significantly in relative terms because of the low yields and the yield curve flattening trend, while additional selected opportunities are available also within healthcare and telecoms in the defensive space favoured versus the bond proxies extremely expensive. We believe that **sector rotation** will continue, as we have seen during market correction, and this could open up opportunities for active selection.

Stoxx 600- sector rotation during May sell off



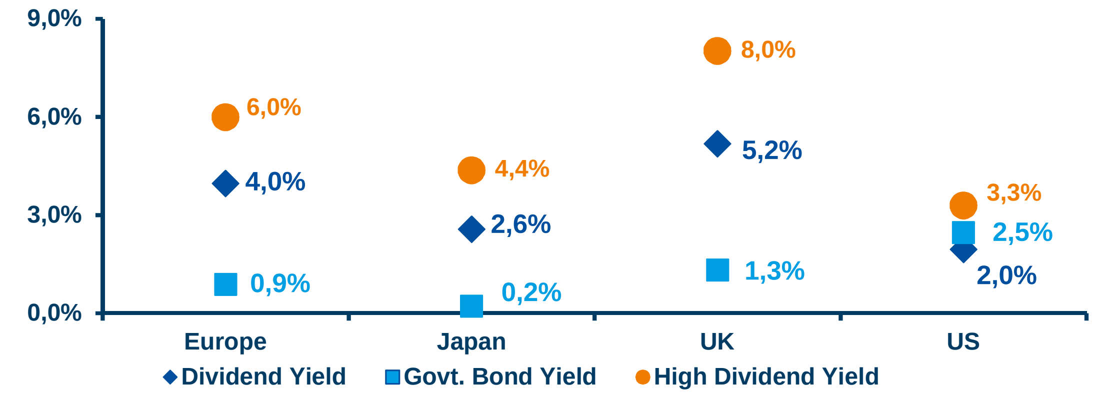
Source: Amundi analysis on Bloomberg. Data as of 6 June 2019.

Theme 3. Long-term themes (search for yield and ESG)

"High dividend yield vs bond yield further back the case for increasing appeal for long-term equity investing in Europe".

Among other factors that could support the appetite for European equities is the **dividend yield** attractiveness vs bond, which is historically high.

Bond yields vs equity dividends



Source: Amundi Research, Bloomberg Data as of 29 May 2019.

"Europe is home of high quality companies with strong business models and focused on improving their ESG profile".

Lastly, taking a longer term perspective, we see European Equity as the right space to play the **sustainability theme**: Europe is the home of high quality companies with strong business models that will not go out of favour, branded consumer goods and industrials. On the issues of sustainability many European companies have the solutions to the challenges. Especially in a world where overall valuations are not particularly compelling, sustainability of business model, balance sheet strength and valuations will be key. Sustainability means also ESG (environmental, social, and governance) focus: ESG is in our view a structural trend which is gaining traction among corporates and investors. European companies have a good ESG record from a relative perspective, but have further to go. Growing evidence suggests that companies with improving ESG fundamentals tend to outperform the market. We believe that this will continue to be an area of focus and opportunities for investors in the years to come.

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Definitions - Cyclical vs. defensive sectors: cyclical companies are companies whose profit and stock prices are highly correlated with economic fluctuations. Defensive stocks, on the contrary, are less correlated to economic cycles. MSCI GICS cyclicals sectors are: consumer discretionary, financial, real estate, industrials, information technology and materials, while defensive sectors are consumer staples, energy, healthcare, telecommunications services and utilities.

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