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Key takeaways

- Headlines have dominated negative sentiment - it is important to take a more fundamental long-term approach to European equities.
- Domestic demand continues to drive the European economy.
- Valuations are attractive in many sectors.

Equity investors, both in Europe and globally, have had plenty to deal with in 2018 - the first populist government in Italy, a political crisis in the UK, trade wars and generally weaker macroeconomic data. Consequently, European equities have been heavily sold off as investors reacted cautiously, ignoring by and large robust macroeconomic and earnings fundamentals.

Are things that bad?

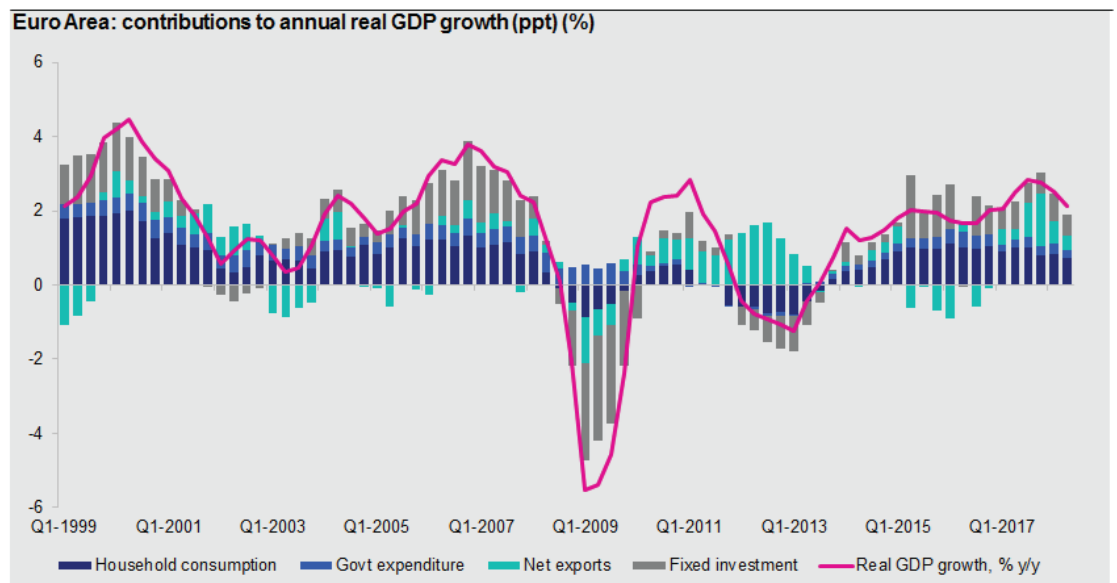
There's no getting away from how pessimistic investors have become. Tarnished by various crises in the last 10 years or so it's easy to be gloomy. What matters to us as fundamental, valuation based investors is to assess if the outlook is as negative as what's being priced in. Even if things are only 'less bad' there are opportunities to be had.

To us the outlook for domestic demand looks good as Europe recovers from the various crises of the last decade. Corporates are regaining their appetite to invest again whilst falling unemployment and rising wages are supporting consumption. So what about the macro weakness we've seen more recently? Q3 economic data has been distorted by the disruption caused in the auto sector from the introduction of new WLTP emissions regulations. This headwind should now fade if the more recent data is anything to go by.

Can trade tensions overshadow domestic demand? If there was an escalation of trade wars, this would almost certainly impact growth but we cannot ignore the strength of domestic demand. This should at least provide some mitigation in a very negative scenario and leave the economy better placed to bounce back afterwards. All in all Europe is still on track to deliver steady if unspectacular growth.

Another encouraging sign of Europe gradually returning to normal after various crises is inflation. Core CPI, the more relevant gauge, has been steadily ticking up for some time now. Wage growth, a key driver of inflation, is firmly on an upward trajectory not just in Germany but in the periphery too. With employment set to rise in 2019 the omens look good. Overall this should provide a solid economic platform - a combination of robust demand and improving pricing trends - for European corporates.

It's hard to ignore - despite the various political headwinds - how robust earnings are. Most indices - be they Pan European, Continental European or Eurozone - are on course to deliver mid to high single digit EPS growth in 2018. It's not all from Energy either. Banks and Insurers have played their part too.



Source: UBS, Haver as at 31 October 2018. Data as at 30 June 2018 (latest available.) Differences between the sum of the individual components and the total are changes in inventories.

If anything more of this growth is coming from those sectors directly exposed to economic trends. Based on our top down macro view and in the absence of any external shocks there seems little reason to believe this can't continue. All of this leads to a region in good shape, helpful for those European corporates more exposed to the economic cycle.

This view also questions the extent to which current monetary policy is required. Yes, support from the ECB is still necessary but would expect this to be gradually reduced over time given the current outlook for inflation and growth. Why is this important? For some time declining bond yields, in part due to ECB policy, have encouraged investors to favour long duration assets over other parts of the market. The valuation gap between these type of assets and other parts of the market is very extended to us. A change in interest rates would require investors to question this assumption.

Where are we finding the best opportunities?

When markets are as polarised as they currently are, you have to build portfolios which express a firm view based on fundamental analysis. Our approach has long been based on valuation: we look for mispriced stocks in all sectors of the equity market and we find that the disparities between stocks, sector and styles are particularly wide at present. Indeed, the most attractive valuations are currently to be found at the value end of the spectrum. 'Value' doesn't mean 'bad companies': we can find many high quality businesses to invest in in a wide range of sectors: financials, telecoms, energy, pharmaceuticals, food retail amongst others.

What could go wrong?

As with all things there are risks. Today most of these are political. Since the Global Financial Crisis we've approached such issues in the same way. We assess each situation and conclude what is the most likely outcome. For Italy the key question is if recent events are likely to lead to a European systemic crisis. For that to happen much would have to go wrong from here.

Looking at opinion polls there doesn't look to be much appetite for a referendum on the Euro - most surveys point to a firm majority in favour of the Euro. Yes, a complicated situation, but not as bad as some of the headlines occasionally suggest. What about the UK? Whatever the outcome - and difficult to know at this stage - is more of a domestic issue as opposed to having any material long term impact on the rest of Europe.

In conclusion we would point out the importance of focusing on fundamentals - which in general are robust - and not to get too hung up on some of the more scary headlines out there. If the outcome is not nearly as bad as current valuations suggest we believe the asset class can do well, even more so for the areas we are exposed to.

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